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Missed and new opportunities in world trade

Guest Editors ▪ Csongor István Nagy and Zoltán Víg

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Editorial: Missed and New Opportunities in World Trade

CSONGOR ISTVÁN NAGY*

International trade has recently seen turbulent times. It has been subject of heated political and social debates and has generated an animated scholarly discourse. It is not an exaggeration to say that international trade is entering into a new age, where tariffs are no longer the major constraints (though they may still be high in certain sectors) and states endeavor to gain additional benefits through boosting trade via diminution of non-tariff barriers.

In this era, bilateralism and regionalism carries the day. In line with the Doha Trade Round's balking, which made the furtherance of the global multilateral system stall, a new generation of free trade agreements has been emerging. These agreements are comprehensive, ambitious, cover the whole spectrum of trade items (goods, services, technology, capital etc.) and have the makings of creating a new governance for international economic relations.

This story, as noted above, no longer centers around tariffs and quotas. Though customs duties have certainly not lost their relevance, they share the scene with various other issues, such as regulatory cooperation, protection of value standards (labor rights, environmental protection), investment protection, public procurement, to mention a few. All this necessarily imposes further limits on national regulatory autonomy and calls for the re-conceptualization of the fundamental notions of global governance, state sovereignty and regulatory autonomy.

Nonetheless, new generation free trade agreements' reception has not been devoid of social outcry and political upheaval. The United Kingdom's secession from the European Union and the new US administration's policy to call off the EU-US Free Trade Agreement (Transatlantic Trade and Investment Partnership, TTIP), cancel the Trans-Pacific Partnership Agreement (TPP) and renegotiate the North American Free Trade Agreement (NAFTA) all prove that the reception of the new era of free trade has not been every time positive.

New generation or next generation free trade agreements have brought about harsh criticism from various angles, mainly because of their tendency to deal with numerous issues beyond trade proper.

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> Let me come to TTIP. I think that's a particularly bad agreement. And let me say why. It's not about trade. Trade barriers between Europe and America, tariffs have already come down, basically, very, very well. Little changes in the exchange rate do more to change competitivity than wiping out the tariffs. So, the fact is that the instability in exchange rates caused by lack of harmonization in monetary policy is a far bigger impediment to trade than any of the tariffs. (…) So this is an attempt to increase the power of corporations to run our economies and our societies. It's not a trade agreement.[1]

The spearhead of the criticism is national regulatory sovereignty, democratic legitimacy and the distrust in foreign standards.

> [These agreements are] no ordinary free trade deal[; they raise] questions about the political future of independent nations, about sovereignty, democracy and indigenous self-determination, and, above all, the people's right to know what governments are doing.[2]

> The proposed trade deal is a huge threat to our democracy and our sovereignty. We have seen the UK participating in a disastrous race to the bottom on corporate tax rates and wages. We must not also walk into lowering our workers' rights, environmental standards and food health standards. Chicken carcasses washed in bleach, hormone-stuffed beef and open season on pollution are not things we want to import from the US.[3]

The apocalyptical visions on international trade's impact on national sovereignty and democracy seem to be highly excessive, in particular because there is nothing in these agreements making subsequent rectification, correction or even denunciation impossible. Still, it has to be made clear that there is, indeed, an inverse proportionality between the wealth benefits of trade and national regulatory sovereignty. A level playing field necessitates a framework based on rules, and rules, even if accepted voluntarily, do limit the freedom of action of those who agreed to them.

Unfortunately, there is no way to boost the fruit-bearing of trade, while treating national regulation untouchable. Free trade agreements prohibit the use of regulation for protectionist purposes, consequently, national measures restricting trade may have to be justified and defended before a dispute settlement body. Free trade surely does not put up with unlimited national regulatory sovereignty. Still, though much depends on the details of

1 An Interview with Nobel Laureate Joseph Stiglitz: The loss of the American Dream, Trickle Down Economics and Free Trade, presented by General Economic Dynamics, 6 October 2015. <https://ged-project.de/videos/competitiveness/an-interview-with-nobel-laureate-joseph-stiglitz/>. A transcript of the interview is available at íhttps://citizenactionmonitor.wordpress.com/2015/12/16/nobel-laureate-economist-joseph-stiglitz-heaps-scorn-on-tpp-and-ttip/> both accessed 17 November 2017.

2 Jane Kelsey, No Ordinary Deal: Unmasking the Trans-Pacific Partnership Free Trade Agreement (Bridget Williams Books with the New Zealand Law Foundation, 2010).

3 Natalie Bennett, Green Party leader, quote available at <http://www.bbc.com/news/uk-politics-30493297> accessed 17 November 2017.

the architecture, this does not imply that states are deprived of the possibility to pursue local legitimate ends.

Recent developments also suggest that the internationalization of free trade can be slowed down but cannot be halted. Xi Jinping, the president of the People's Republic of China, noted that '[p]ursuing protectionism is just like locking oneself in a dark room.'[4] Indeed, missed opportunities may give rise to new opportunities for others.

All in all, the process of trade liberalization did not stall. Though after a tumultuous process, the Canada-EU Free Trade Agreement (Comprehensive Economic and Trade Agreement, CETA) was finally signed and provisionally went into effect on 21 September 2017.[5] In the same vein, negotiations for the EU-Japan Economic Partnership Agreement were finalized on 8 December 2017. The JEFTA will be submitted for approval to the European Parliament and the EU Member States by the European Commission after the legal verification and translation processes.[6]

The withdrawal of the US from the TPP did not to put an end to the trans-pacific initiative but simply brought about an economic region without the US (TPP 12-minus-one agreement). The remaining 11 signatories went on with the project without the US[7] and in January 2018 agreed to conclude the TPP-11, renamed as Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the formal signing ceremony to be in March 2018.[8]

It should not be disregarded that nowadays trade liberalization is not only about what to gain but also about what to lose.

Whoever stays out misses out. Not being part of a free trade zone confers a competitive disadvantage. It is widely accepted that free trade agreements have significant trade

[4] Tharoor, Ishaan, 'China casts a long shadow over Trump and Davos' (26 January 2018), available at <https://www.washingtonpost.com/news/worldviews/wp/2018/01/26/china-casts-a-long-shadow-over-trump-and-davos/?utm_term=.35bd8cf722b2> accessed 27 January 2018.

[5] Council Decision (EU) 2017/38 of 28 October 2016 on the provisional application of the Comprehensive Economic and Trade Agreement (CETA) between Canada, of the one part, and the European Union and its Member States, of the other part. OJ L 11, 14.1.2017, p. 1080–1081. See Press Release: EU-Canada trade agreement enters into force (20 September 2017), available at <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1723> accessed 17 November 2017. CETA is a mixed agreements which comes under both EU and Member State competence, it may go into effect only once it is approved in all the Member States. Since these approval procedures may take numerous years, the EU Council, as allowed for by Article 30.7 (Entry into force and provisional application), made those elements of the CETA that come under EU competence provisionally applicable, until final approval is pending in Member States. Provisions not yet in force concern investment protection, market access for portfolio investment (with the exception of foreign direct investment, as this comes under exclusive EU competence) and the Investment Court System.

[6] Press Release: EU and Japan finalise Economic Partnership Agreement (8 December 2017), available at <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1767> accessed 31 December 2017.

[7] Shaffer, Sri Jegarajah, Craig Dale, Leslie (2017-05-21). 'TPP nations agree to pursue trade deal without US'. CNBC <https://www.cnbc.com/2017/05/20/tpp-nations-agree-to-pursue-trade-deal-without-us.html> accessed 17 November 2017.

[8] Swick, Brenda C. and Augruso, Dylan E., 'Canada Reaches Comprehensive and Progressive Trans-Pacific Partnership Agreement' (29 January 2018), available at <https://www.natlawreview.com/article/canada-reaches-comprehensive-and-progressive-trans-pacific-partnership-agreement> accessed 30 January 2017.

diversion effects.[9] Under the CPTPP, Japanese enterprises may purchase Australian products even if they are more expensive than the American ones. The former carry no tariff burden and may be more compliant with Japanese standards. It is not a surprise that there is a global rush for membership in trading clubs.[10]

Furthermore, trade is not only about the benefits of local consumers in the form of enhanced surplus due to lower prices. In the global factory, having cheap input products determines the competitiveness of the output products. It might be painful to see that a high-wage country's company outsources elements of the production process to a low-wage country, thus 'taking jobs away'. However, preventing them from doing that generates higher manufacturing costs, while in the world market they have to compete with companies which do take advantage of the cost-benefits of low-wage countries. Again, whoever stays out misses out.

This special issue addresses selected aspects of international trade's above developments with papers on Africa, the Americas, Asia and Europe. It is based on the proceedings of an international conference that took place on 12 April 2017 at the University of Szeged, entitled 'Missed and new opportunities in world trade: is Trump China's trump in world trade?'.

The first paper, 'Multilateralism and Regionalism in International Trade Law', is authored by Professor János Martonyi, Hungary's former minister of foreign affairs and professor emeritus at the University of Szeged. The author gives an account of the growing economic, political, ideological, institutional and legal challenges of international trade.

Professor Stefan Messmann, former professor of the Central European University and former Deputy General Manager and Commercial Executive with Shanghai Volkswagen, in his paper entitled 'A German Lawyer in the Far East: Investing and Doing Business in China', gives an insider's overview on the comprehensive issues of investing in China through the lenses of a practicing lawyer.

The paper of Professor Harrison O. Mbori (Strathmore University Law School, Nairobi, Kenya), 'Combating Unjustified Sanitary and Phytosanitary Measures in the African Tripartite Free Trade Area (COMESA-SADC-EAC): SPS-Plus or SPS-Minus?', addresses the hot issue of sanitary and phytosanitary measures from an African perspective.

9 See Viner, Jacob, 'The Customs Union Issue' (1950) 4 Journal of the History of Economic Thought 491–515 (1950); Lipsey, Richard G., 'The Theory of Customs Unions: Trade Diversion and Welfare' (1957) 93 Economica New Series 40–46; O'Brien, Denis P., 'Customs Unions: Trade Creation and Trade Diversion in Historical Perspective' (1976) 4 History of Political Economy 540–63.

10 See Gantz, David on Ford in China (comment posted on 22 June 2017), available at <http://worldtradelaw.typepad.com/ielpblog/2017/06/david-gantz-on-ford-in-china.html> accessed 20 November 2017:

Am I missing something with the announcement that Ford will build a new plant in China to build the next generation small car (Focus)? I believe that this was the plant that Ford originally planned for Mexico, but changed its mind after criticism from Mr. Trump. (Apparently, Ford's existing US plants are busy with much more profitable SUVs and small trucks.) It seems to me that the major result of the decision to build the plant in China rather than in Mexico is that while the vehicles produced in the Mexican plant would likely have used 35–40% US parts and components (to meet the 62.5% NAFTA value added requirements), the Chinese made Focuses will likely have little or no US parts content. Ford will probably save enough money in using cheaper Asian parts to more than offset to 2.5% duty assessed when the finished vehicles enter the United States. Somehow, this doesn't seem the best way to preserve manufacturing jobs in the US. Or am I missing something?

The paper of Dr. Sanford U. Mba (doctoral researcher at the Central European University), 'Africa for the Chinese'? Revisiting Sino-African Bilateral Investment Treaties', deals with the intensive trade and economic relations between Africa and China, which resulted in a huge influx of foreign direct investment from China to African states. It analyses the challenges raised by standard BITs and how China-Africa BITs have dealt with those challenges.

Professor Manuel A. Gómez, Associate Dean at Florida International University's College of Law, in his paper titled 'The South American way: sub-regional integration under ALBA and UNASUR and international dispute resolution', analyses two of the most recent South American sub-regional integration efforts: ALBA and UNASUR.

The paper of Professor Zsolt Bujtár and Professor András Kecskés, titled 'Hedging your bets? – An overview of the legal aspects of hedge funds', gives an outline of certain legal aspects of hedge funds as a controversial element of the global financial system.

The special issue's concluding paper, authored by Professor Zoltan Víg (University of Szeged) and Professor Tamara Gajinov (Union University, Serbia), titled 'Challenges Facing China', address the future prospects of one of the globe's largest economic giants. It examines economic and other challenges that China is facing. such as the completed cycle as a high-growth-low-wage country, corruption, lack of cheap labor-force, lack of market liberalization and political issues.

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Multilateralism and Regionalism in International Trade Law

JÁNOS MARTONYI*

Abstract: International trade has been tested by a growing number of economic, political, ideological, institutional and legal challenges. On the one hand, the future of the global trading system depends largely upon the development of all these 'external', uncertain and unpredictable risks and opportunities of various natures. On the other hand, international trade and the functioning of the global trading system is one of the major factors that have a significant impact upon the shaping of the present and future world order.
Keywords: multilateralism, regionalism, international trade law, free trade

Trade has always been the generating force of economic growth, employment, prosperity and progress of humanity. The forms, the objects, the technics and the rules have always been changing throughout history. These transformations are rapidly accelerating but the substance and function of exchanging the products of human activities on a local, regional and global level have remained essentially the same – creating wealth and promoting welfare. What used to be limited to the exchange and physical movement of goods has been extended to services of all kinds and now more and more engulfs the flow of data.

The fundamental shift in the relation between the trade in goods, the trade in services and the flow of data, due to the breath-taking development of technology – the new phenomenon of 'deep-tech' and all that it entails, create the impression that trade is losing its importance and the main transformation is taking shape outside the traditional sense of trade. However, deep-tech does not diminish the role of trade in the widest sense, i.e. exchanging everything that is created physically or intellectually by humans, including algorithms for robotization, automation or ultimately artificial intelligence.

It is true that the volume of goods moved around the world, in particular the goods carried by sea, is not increasing but is on the wane, in relative to trade in services and also the global economic growth. At the same time, supply chains become even more complex, increasingly relying on new technologies, substituting data for components. All in all, the ancient devise 'navigare necesse est' is still valid and in a more abstract sense, it is more relevant than ever.

The deep-rooted and sweeping transformation in the nature, structure and forms of international trade has resulted in both macroeconomic theory and political doctrine becoming fundamentally divided on a long range of issues, previously considered as simple evidences based on conventional wisdom.

Are bilateral trade balances still (or again) relevant or in a multilateral world economic system bilateral imbalances may be considered irrelevant? What are the main causes of perennial bilateral deficits? Are there general macroeconomic reasons behind these imbalances, such as excessive spending and saving on the other side? Or it is the 'manipulated' value of some countries' currency, or the unfair rules established by

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multilateral or by regional agreements or, indeed, their persistent violations that are to be primarily blamed for all these disequilibria and controversies.

Conflicting economic theories, diverse and opposing ideas and arguments are swirling around in academic, as well as, in public discourse and make – directly and immediately – their way to heated political debates. Correlation is confused with causation and vice versa. Political ideologies step in and make a once scholarly and intellectually attractive, but in broader political debates somewhat neglected, subject the area of fiercest debates – a battlefield of ideological and political clashes. TTIP, TPP, NAFTA are only some of the cases in point. The war is therefore economic, political and cultural alike and the conflicts between national interests are compounded by deep ideological divides that are made instrumentals by political movements for their own political purposes. The conflict between the regulatory autonomy or sovereignty of states and the beyond the border regulatory efforts of the new generation free trade agreements also reflects in the most spectacular manner the deepening ideological divide which is ultimately rooted in the diametrically opposing views relating to the tackling of globalization and the visions on global governance.

The internal conflicts and challenges of the world trading system are aggravated by the geopolitical challenges, tectonic shifts and rumbles from all around the world. The 'great shift' in the economic and geopolitical power structure of the world, the absence of a single dominant power or hegemon, the growing fragmentation of the economic, geopolitical and cultural world order, the rise of a multi-actor, multi stake-holder world, the re-emerging spheres of influence, the growing antagonisms and all the risks and threats entailed by them supply the basic framework and background for an international trading system fighting for its survival and for the saving of its tremendous achievements of the last 70 years.

The role of legal scholarship in this situation, characterized also by excessive rhetoric, should initially be, to calm down the excitement, 'calmer les esprits' and to take an objective, reasonable and balanced approach, distancing itself from ideological motives and sentiments.[1] Thorough analysis must be conducted at the same time, based upon reliable research and data in order to lay down the groundwork for future rule-making on local, national, regional and global level.

The global trading system, as established and developed by international trade law, stands on two interconnected pillars: International – multilateral and regional (bilateral) – rule making and the adjudication of disputes on the basis of all these regulatory instruments.

It is well known that the multilateral trade regulations came to a standstill around 20 years ago and since then, they seems to be in a frozen state. Minor achievements have been made, such as the Trade Facilitation Agreement (Bali, 2013) or the Information Technology Agreement (extended in Nairobi, 201 this being the first major tariff cutting deal on an MFN basis since 1996), but most of the original aspirations of the Doha Round simply have failed and are not to be expected to materialize even at a longer term.

The substantial increase in the number of participants in the global game, the changes in their economic weight and political clout and the absence of timely adaptation to them certainly has contributed to the deadlock in the multilateral rule-making. Another reason is the over-stretching of the scope or coverage of the regulations. The existing structure could no longer carry the multiplied weight of more and more targeted areas of law-making. On a more general level and in a deeper context, the freezing of the multilateral regulatory

[1] Martonyi (2016).

process also reflects the overall gridlock in the functioning of the global institutions or global governance.

The realistic objective that can now be set for the future development of the multilateral regulation of world trade is, first and foremost, the preserving and maintaining of the present system with all the substantial achievements. At the same time, the 'global acquis' of the regulatory system should and can be improved, developed and aligned with new demands and realities in some specific, limited areas. This has been the case in recent years. 'Save what we have', 'maintain it in workable shape' and 'keep the power dry' for the future can be the basic aspirations for the multilateral (global) rule-making in the present situation. Developments on other levels of regulation will further unfold, and are in many fields equally or even more suited to tackle the issues of international trade which itself, as has been seen, happens to be in deep and accelerating transformation. It is not only trade in the widest and more abstract sense that is rapidly changing, but also the social, political and economic demands and expectations are intensifying and have an even stronger impact upon all kinds of rule-making.

The multilateral trade regulation seems to have reached its limits which also appear to be in line with the apparent, structural or conjectural?, slowing down of globalization whilst the other pillar of the world trading system is still in fairly good shape and functions satisfactorily. The dispute settlement system of the WTO is often referred to as the 'bright spot' of the international trading system[2] handling a growing number of complex and serious disputes between various members of WTO with a very high ratio (90%) of compliance. The freezing of the rule-making branch of the system and the unfulfilled needs for adjustment and development of the rules has obliged the dispute resolution mechanism, in a way, to take over some of the tasks of the regulation and has to resolve issues that should normally be tackled by the organic development of the legislative process. The DSS of the WTO has therefore become the 'victim of its own success' and is being flooded by disputes in growing number and complexity. The system is more and more overloaded. Non-trade issues are on the rise, panels and the Appellate Body are confronted with the need to balance between disgeneric values which make their task sometimes close to impossible. At the same time, it is mistaken to believe that the DSS, that is the judicial function, can take over not only part of the legislative function, but also the 'whole pain of the world' from environment protection to labour law, from SPS to social welfare or from data protection to human rights. The result is the increasing length of the procedures and also the decrease in prompt compliance.[3]

The multilateral DSS remains to be the most successful area of the world trading system despite these and other challenges. It is not perfect, but is fair and efficient. This is the reason why the multilateral dispute settlement seems to be winning the 'competition' with the dispute settlement mechanisms of the regional trade agreements. There is an ongoing academic discussion on the relationship and the possible jurisdictional conflict between the two mechanisms but the 'vast majority of RTA – DSMs have not been used at all', and even the 'FTA partners continue to use the WTO dispute settlement mechanism to resolve disputes between them'.[4] One of the reasons for this preference for the WTO mechanism is no doubt its more legalistic character both in a substantive and in a

[2] According to Sacerdoti 'the Dispute Settlement System (DSS) of the WTO continues to be considered a success story, and rightly so'. Sacerdoti (2016) 46.

[3] Sacerdoti (2016) 47–49.

[4] Chase et al (2016) 610.

procedural sense. The level of commitments, of course, differs as RTAs essentially aim to establish free trade with rights and obligations going well beyond the multilateral framework. The RTA – DSMs represent a wide range of models, from the pure political-diplomatic consultation to quasi-juridical and juridical systems or even a supranational model with direct effect of the decision adjudicating the dispute.[5]

The bright spot of the international trading system is, however, exposed not only to legal or procedural risks, but also to threats of general and fundamental nature. The dark clouds seem to be assembling on the horizon of the multilateral trading system. The general political and economic background also have a negative impact upon the judicial function. If this function is severely damaged, the overall system might receive a mortal blow. This is why all efforts must be developed in order to improve the dispute settlement system itself, adapting it to the new challenges, as well as to the political and economic realities.

Procedural improvements of the dispute settlement mechanism are needed and would, undoubtedly, be helpful. Whatever all these corrections will be, it must be clear, however, that the judicial function cannot, by itself save and secure the future of the multilateral trading system. The dispute settlement mechanism will be unable to appropriately fulfil its function without a solid legislative background, a basis of non-frozen rules, but evolve, adapt and develop according to the changes of the economic and political environment. The legislative and judicial function cannot be separated and are ultimately not only interlinked but also interdependent – one cannot live without the other. The ambitions for the revival of the rulemaking are still there and in the light of several statements it seems this time again, that hope is the last thing to die.

It cannot be contested that one of the main reasons for the rapid growth of RTAs has been the deadlock in the multilateral rule-making of WTO. At the same time, the differentiation of the multilateral system started well before the slowdown or the standstill in multilateral rule-making. It started with the birth of the system by including Article XXIV in the GATT, 1947. Exceptions from and derogations to the principle of equal treatment as implemented by MFN treatment widened both in law and in practice. WTO was established what used to be the general rule with limited exceptions became in reality the exception.[6]

This tendency was substantially accelerated by the special bilateral or regional (plurilateral) agreements based upon Article XXIV of GATT, Article V of the General Agreement on Trade in Service (GATS) or paragraph 2c of the Enabling Clause. The cornerstone of the multilateral system was the fundamental principle of equal treatment and the objective was to achieve progressive multilateral liberalisation, not to establish free trade – the purpose of the RTAs' was precisely the opposite. The objective here has been to establish special regimes, in most cases free trade between the parties. These agreements are by nature discriminatory granting special rights and benefits for their parties and by the same token, depriving the non-parties of the same rights and benefits.

By the end of 2016, there were 271 RTAs in force and notified to the WTO under the Transparency Mechanism of RTAs.[7] In case agreements for goods and for services are counted separately the number of RTAs in force and notified was 461, while the overall number concluded and notified was 629. An unknown number of RTSs has not been notified

[5] Chase et al (2016) 618–21.

[6] Martonyi (2015).

[7] Recent Developments in Regional Trade Agreements, INT/SUB/RTA/153, July–December 2016.

and therefore does not appear in the WTO Transparency Mechanism. 20% of all RTAs in force are European, 17% are in East Asia, 12% in South-America and 9% in the CIS region. The European Union has by far the highest number of RTAs. This number is in line with the EU's growing global outreach and will be further increasing. The United States (20) and China (14) follow the EU from a significant distance. The difference between the US and the Chinese number will soon be reduced and probably reversed due to the US step back from TPP (and perhaps other decisions to follow) and also as a result of the Chinese expansion, not only by filling the Asian vacuum created by the US, but also as part of a global geopolitical and economic ambition. The new bilateral or 'transactional' approach taken by the US and a more active Chinese trade policy driven by a growing assertiveness and a global vision and aspiration might reverse not only the relationship between the number of RTAs, but also affect the geopolitical and economic power balance between the two superpowers. Conclusions, however, should not be hastily drawn, given the complexity of the various factors and the uncertainty of developments. One, often somewhat disregarded, factor is the overwhelming advantage of the United States in the field of 'soft power'.

The RTAs growth has not been limited to their number but extended also their coverage as their scope has become more and more comprehensive, including provisions on intellectual property, competition, government procurement, investment and also regulation on the protection of human and animal health, environment, labour, social welfare and human rights. The overstretching of RTA coverage means that RTAs' world has been encountered by very similar challenges to those previously met by the multilateral regulation. The consequences of the extension of the regulated areas are, however, very much different in the multilateral rule-making and in the RTAs. RTAs are essentially free trade agreements, their regulations go much further 'beyond the border' and interfere much deeper with the national regulatory autonomy of the parties. This is where the serious political conflicts enter and turn into ideological clashes between the two sides of the deepening divide, increasingly instrumentalized for political purposes. This is the ideal terrain where 'globalists' and 'sovereigntists' can display and advocate their emotionally laden ideological and political prejudices, This can jeopardize the efforts aiming at the promotion of more free, more fair and more rule-based trade – rules that also have the basic function to protect and to safeguard the interests of the smaller and the weaker.

One way of easing the tension created by conflicting world visions could be to exercise more restraint in the widening of the scope of the agreements, the original function of which happened to be the promotion of free and fair trade. Political controversies are, in any case, hard to avoid, given not only the opposing ideological convictions, but also the underlying material, indeed, economic interests.[8] It is also to be noted that quite frequently the same political and societal movements that demand respect for the regulatory sovereignty of nations strongly request the validation of social, labour and human rights for other countries, hence the inclusion of such provisions in the agreements.

Geographic proximity, economic policies, supply chains and geopolitics are the four drivers behind the establishment and shaping of RTAs and for at least a decade, the third and fourth factors have steadily been gaining importance. At the beginning of RTAs, it was clearly the geographic proximity was most visible factor – free trade areas or customs unions were essentially developed between or among neighbouring countries. Economic

[8] Nagy (2018) 203–205.

and social philosophy determining the political, social order as well as the economic and trade policies of the potential partners of an RTA also used to play a decisive role, as free trade was (and still is) unimaginable without a certain level of market economy and, accordingly, WTO membership. RTAs have been progressively establishing free trade and increasingly have come into being between not only geographically remote countries, but also parties whose economic, social and political orders show significant discrepancies. ASEAN was the first, but not the last evident example for this, where the 'ideological diversity' is compounded by the huge differences in the level of economic development. (Laos and Singapore.) Now, new RTAs have been concluded or are being negotiated between parties separated both by geographic distance and political philosophy e.g., EU–Vietnam, China and Chile or Switzerland.

Both the regional and the global economy are now based on supply chains that are now the major factors in the establishment of RTAs. On the other hand, RTAs themselves buoy up supply chains by stimulating and facilitating the free movement of goods and services becoming part of the supply as well as value chains. Hopefully be able to avoid the catastrophic consequences of a long-standing and well-functioning free trading regime, a single market, ceases to exist can be avoid thereby disrupting innumerable vital supply chains developed over several decades between the EU and the United Kingdom.[9]

In line with the general geopolitical developments, in particular the exacerbation of power struggles and confrontations of economic interests, the geopolitical factors also have a significant impact upon the establishment of RTAs. The best well-known example is the TPP where the original geopolitical objective of the United States was evident: The creation of an economic area, to develop closer ties with all the other 11 Asian, North and Latin-American nations and exclusion of China, the great geopolitical rival. The withdrawal of the US will also have geopolitical consequences, precisely the opposite of what was the original intent. China will likely take the place of the US and that will not only shift most of the economic benefits to the Middle Empire but it will re-enforce the Chinese geopolitical position and power in and well beyond the Asian region. Whether the economic withdrawal can be off-set by increasing military capabilities and power is an open – and somewhat ominous – question.

There is an older and closer demonstration of the sometimes preponderant role of geopolitics in creating RTAs. It is the European integration process where the original purpose was preponderantly political. Only after the treaty on the European Defence Community was voted down by the French National Assembly in 1954 was the idea of progressively creating an economic integration and thereby laying down the economic basis for an ultimate political union of Europe ('finalité politique') was put on the table by ingenious 'technocrats' like Jean Monnet. In doing so, he also invented the great technique of the 'méthode communautaire' that has been the key driver of the organic and incremental development of the European construction for at least for half a century. It is another question that the 'technocratic' approach has now been exhausted, in part because of its excessive overreach creating thereby problems that it could not resolve. Again, a 'victim of its own success'. Now it is high time to revert to the origins and to the somewhat forgotten principle of the 'finalité politique', adapted to the new situation in the world, primarily in the external relations of Europe.

[9] Martonyi (2016).

Whatever are the key drivers of the RTAs, they show a very high level of diversity, not only because of the differing factors and purposes behind them, but also due to the very different historic, economic and political situations in which they come into being. They are diverse in their coverage, structure, legal techniques, substantive provisions, rights, obligations, dispute settlement mechanisms and hence are not easy to be classified in various groups or models. This reflects the growing differentiation of the overall trading system starting originally within the multilateral framework, and later continued and deepened by the spreading of all sorts of bilateral, regional, plurilateral free trade agreements (as well as customs unions). However, behind this overwhelming trend of differentiation and fragmentation, there are apparent commonalities, principles and general features that may represent the groundwork for a future re-unification of the international trade rules. It should not be forgotten that the historic and legal background for the establishment of GATT was the sophisticated network of bilateral trade agreements based upon the MFN treatment that was ingeniously multilateralized in the new situation after the Second World War.

All these developments taking place in the international trading system reflect and demonstrate the general economic and geopolitical trends. Globalization slows down but goes on, regionalization, localisation is on the rise, but is intertwined with universal and common elements.

Geopolitical power and responsibility progressively devolve to regional levels, the diffusion of power decentralizes governance and rule-making but global risks and opportunities demand common action and universal (multilateral) rule-making.

These two competing and, at the same time, complementary tendencies are present not only in geopolitics, in the global economy and in the international trading system, but also in what is called 'soft power' or, indeed, culture in the widest possible sense. Culture tends to be belittled as the ultimate mover of all the other areas as the majority of attention is focused upon the economic and geopolitical (including military might) parts of the equation. 'It is culture that matters', culture essentially creates and forms economy, politics and all the other areas of human and social activities.

Rule-making is part of culture and as such does not only reflect, but also develops and shapes geopolitics as well as the economy. If this is true, then it is possible not only describe and analyse what is going on and why, but there is the possibility, the capability and the responsibility – by local, national, regional and universal rule-making – to influence, to shape and to improve the world's security, stability and prosperity.

Rules are getting more universal and fragmented at the same time, the world which was supposed to be flat is more and more divided, and power is more devolved. The economy and trade is inherently interdependent and multilateral but regional and bilateral endeavours increasingly pervade the whole system. Culture is diverse, collective identities differ (dialogue, not clash!), but it cannot dispense with some universal values that many believe, are of absolute nature. In this complex, tumultuous competition trade, free, fair and rule-based trade with a strong multilateral dimension has a vital role to play.

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A German Lawyer in the Far East: Investing and Doing Business in China

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Abstract: Shortly after the end of the Cultural Revolution, some four decades ago, there were no passenger cars in China when Volkswagen AG started its negotiations inthis country. The country was poor and underdeveloped. Today, the GDP of China reached USD 17.6 billion compared to the US' 17.4 billion USD. Car production in China is now more than 18 million cars per year, more than in the USA. Today, China is still a socialist country and its economic system is called 'socialist market economy' but there are about 50 million private companies, 400 million people are belonging to the middle class and there are about 800 super rich having more than 100 million USD on average. In this 'sino-marxist' country, there are even 130 multi billionaires in USD. No wonder that under these circumstances, joint ventures and wholly foreign-owned enterprises, especially also in the automotive industry, are welcome.

Volkswagen started its negotiations with its Chinese partner, STAC (Shanghai Tractor and Automobile Investment Corporation), BoC (Bank of China) and CNAIC (China National Automotive Industry Corporation) in 1979. These negotiations ended in 1984 by setting up the 'Shanghai-Volkswagen' joint venture which started the production of the Santana in 1985. Some years later, in 1988, Volkswagen started the negotiations with FAW (First Automobile Work) in Changchun. These negotiations lasted much shorter and the second VW joint venture, 'FAW-VW', started with the production of Jetta and Audi 100, 100, 000 cars per year in 1991.In 2004, the 'Volkswagen Group China' (VGC), a wholly VW-owned holding company was set up in Beijing in order to coordinate the VW-participations, the sales and marketing of its joint ventures, the purchasing, personnel and governmental relations as well as finance. Today, VGC has, including its 16 subsidiaries, 95,000 employees, has built 30 million cars at 30 Chinese production sites and sold them by 5,000 dealers (with 330,000 employees). In 2016, VGC has built about 4 million cars.

Keywords: Volkswagen (VW), joint venture, wholly foreign-owned company, socialist market economy, sino-marxism, Shanghai Automotive Industry Company (SAIC), Shanghai-Volkswagen (SVW), First Automobile Work (FAW), Volkswagen Group China (VGC)

1. INTRODUCTION

The title of this paper, a least the 'A German lawyer…' part, needs an explanation. The Author is a German citizen and has worked in the Foreign Legal Department of Volkswagen AG in Wolfsburg/Germany but he studied Swiss law in French in Geneva; was an attorney in Shanghai and taught International Business Law at the Central European University (CEU) in English in Budapest/Hungary. None of the Author's activities in Volkswagen AG's Foreign Legal Department were concerned with German law but his point of view will be that of a German lawyer as his experiences in investing and doing business in China will be presented from a former Volkswagen lawyer and Deputy General Manager of Shanghai Volkswagen perspective.

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2. BIG CHANGES

Shortly after the end of the Cultural Revolution, some four decades ago, there were no passenger cars in China when Volkswagen AG started its negotiations in this country.

Today, on the other hand, there is almost no space in this country without cars.

In order to explain this big change, and the enormous contribution of Volkswagen AG(VWAG) to this change, the Author will deal first with the actual situation in China, thereafter with its economic and political system, thirdly, with its higher education, which made a large contribution to the economic development of China, fourthly, with the development of the Chinese law, which made possible foreign direct investments (FDI), before entering, finally, in detail to VWAG investment and doing business in this country.

3. CHINA TODAY

China has today a population of 1.388 billion people.[1] Shanghai, the city of the first joint venture of VWAG in China, has 24.15 million people[2] and is the largest city of this country. Changchun, the capital of Jilin province, the city of the second joint venture of VWAG, has a population of 3.815 million.[3]

[1] China Population (2017) link 1.
[2] Shanghai Population (2017) link 2.
[3] Changchun Population (2010) link 3

In 1978, shortly after the Cultural Revolution (1966–1976), only 18% of the Chinese population lived in cities. Today, 51% of the Chinese, i.e., about 700 million, are living in cities which also means a large increase of social wealth.[4] In the next 20 years, an additional hundreds of millions of Chinese may also move to cities.[5] Today, China is the second biggest economic power in the world, after the USA, with the potential to overtake the USA in the next decades, among others according to such experts like *Zbigniew Brzezinski.*[6] Already in 2014, the Chinese GDP reached USD 17.6 million compared with the USD 17.4 million of the USA and it is expected that in 2050 the Chinese GDP will reach USD 61.1 billion against the USD 42.2 billion by the USA.[7] It is no wonder, therefore, that China is attracting more foreign investors. In 2016, the FDI to China was USD 118 billion[8] after USD 10 billion only in 1990 and USD 60 billion in 2000. This FDI went mostly to industry, technology (IT) and leasing sectors but Chinese companies have also started to invest more abroad. Thus, in 2016, FDI from China reached USD 61 billion.[9] Chinese companies, private and state ones, are making frequently purchase tours in the USA and in the EU countries to buy enterprises which have important know-how, necessary for the further development of the Chinese industry e.g., last year, Chinese firms closed overseas deals worth USD 61 billion. This was up by 16% on 2014 and is the highest level on record.[10]

The most FD to China came from Hong Kong and Taiwan and from the EU countries like France, Germany and the UK and predominantly went to Guangdong, Shanghai and Jiangsu.[11]

China is also actually the largest trade partner of the EU and the USA with a trade volume of USD 560 billion in 2016 and thus exports more than the USA and Germany together.[12] It is no wonder that as a result of this fast economic development, China's foreign currency reserves amount to USD 3,000 billion[13] and the Renminbi is today in the basket of currencies of the International Monetary Fund (IMF).[14]

4. CHINESE ECONOMIC AND POLITICAL SYSTEM

China is still a socialist country but its economic system is called a 'socialist market economy'. However, it does not mean that the Chinese economy is a state economy, like other former socialist countries and China before 1978.When Chairman Mao Zedong died in 1976, the average income per person was USD 250 per year but it is now 30 times higher.[15] As a result of this development, there are today about 50 million private companies in China, among them such well-known companies like *Vanke, Geely,* and *Alibaba,* accounts for about 80% of the Chinese companies producing about 60-70% of the country's GDP.

[4] Majority of Chinese Now Live in Cities (2017) link 4.
[5] Population in the cities (2014) link 5.
[6] Brzezinski (2012) 56.
[7] Europa fällt zurück (2015) link 6.
[8] China Daily 2017 (2017) link 7.
[9] FDI from China (2016) link 8.
[10] Better than barbarians (2016) link 9.
[11] FDI to China (2005) link 10.
[12] China's exports (2015) link 11.
[13] Die Weltwährung (2016) link 12.
[14] Der Yuan etabliert sich auf Kosten des Euro (2015) link 13.
[15] Pickert (2017).

About 4,000 new private companies are registered daily in this country though the State's influence on the economy remains high.

The result of such economic development is that there is today about 400 million people belonging to the middle class and about 800 super rich having more than 100 million USD in average and there are even 130 multi billionaires in USD including several women. The richest Chinese is Wang Jianlin, whose father fought under Chairman Mao Zedong, owns a fortune of USD 34 billion.[16] Belonging to the middle class means having an apartment or a house and, of course, a car. In 2016, about 120 million Chinese went abroad as tourists and about 900 million have a mobilephone. It is no wonder that, under these circumstances, the Chinese Communist Party (CCP) is sometimes called *'Chinese Capitalist Party'* by some Western observers.

The long term strategic aim for Chinese companies is to buy more foreign enterprises, especially in the USA and Germany, in order to enhance their technology but are also interested in airports and consumer goods.[17]

Higher education in China also contributed to this fast economic development. There are today 25 million students in higher education in this country, among them 73,000 PhD students in technical subjects, while between 1981 and 2001 there were 'only' 51,000 students in technical subjects. It is also of great importance for China that there are 140,000 Chinese students studying in the USA alone and the common experience, upto now, is that 80% of theses Chinese students studying abroad will return home.

The Chinese political system is generally considered as a 'one party system' though there are eight political parties in the People's Congress, twice as many as in the Hungarian Parliament. The electoral system is also developing, though it is often ignored in the Western countries. For example, on the country level, there is no limitation to the number of candidates for local elections and they must not be necessarily members of the CCP.

The official political system in the PRC in the post-Mao period is often considered by Western China-researchers as 'pragmatic', 'post-Maoist', or 'capitalist' and according to them, 'Maoism' has been replaced by Deng Xiaoping's pragmatism. They refer to a CCP 'Resolution about some questions in our Party history since the founding of the CCP' of 1981, which pointed out the 'grave mistakes' made by Mao Zedong in his 'late years'. The CCP, however, continues to uphold the 'Mao Zedong Thought', except for a few ideas propagated by Mao Zedong during the Cultural Revolution. The *'Mao Zedong Thought'* is, however, only a part of the CCP's 'guide to action'. The CCP *'takes Marxism-Leninism, Mao Zedong Thought, Deng Xiaoping Theory, The important thought of Three Represents and the Scientific Outlook on Development as its guide to action'*. Therefore, an adequate name for the whole system of this 'guide to action', for the actual Chinese political system is *'Sinomarxism'*.[18]

5. DEVELOPMENT OF CHINESE LAW

The origin of Chinese law dates back to a time many centuries before the beginning of the Christian era and had two fundamental characteristics: *Legist* and *Confucian,* consisting in *'the tradition of promulgating dynastic codes and a steady adherence to a set of underlying*

[16] Der reichste Chinese (2015) link 14.
[17] Chinesen kaufen (2016) link 15.
[18] Von Senger and Senn (2014).

principles based on the Confucianist world outlook'.[19] At that time, there was no concept of independent judiciary as the local mandarins acted as judges but a special board, called *Tingwei* or *Dalisi,* acted as the highest court of appeal.[20]

Modernisation started after the Boxer Uprising of 1900 and this including legal reform. In 1906, the first Western-style law school was opened in Beijing and after the Revolution of 1911, the modernization of the law continued and German law seemed to be especially attractive to the new Chinese leadership, because of the military force of Germany at that time.

After Mao Zedong took power in 1949, the Soviet influence also become predominant in the Chinese legislation. It was followed by total lawlessness during the Cultural Revolution (1966-1976).[21] After Mao's death in 1976, a new period started in China, also concerning the development of law.

The most important laws, from the economic point of view, after the Cultural Revolution were the Law on Joint Ventures using Chinese and Foreign Investment (1978); the Law on Foreign-Capital Enterprises (1986); the Law on Sino-foreign Cooperative Joint Ventures (1988); the Law on Establishment of Holding Companies by Foreign Business Entities (2004); the Company Law (revised in 2013) and the Economic Contract Law (1981) as well as the Foreign Economic Contract Law (1985).

These laws made it possible to set up joint ventures and wholly foreign-owned companies, including holding companies, subject, of course, to State approval. The participation ratio for foreign partners in joint ventures is minimum 25% and maximum 95% and for local partners minimum 5%. In the joint ventures, contribution in technology is compulsory for the foreign partner but it is limited to 20% of the foreign invested capital. The joint venture law foresees some limitations in establishing joint ventures, such as the violation of the Chinese sovereignty, of Chinese laws and of the environment, obvious inequality in the contract as well as hindering of the Chinese economy.

For joint ventures and wholly foreign-owned companies, the Special Economic Zones are of special importance because of their export orientation and tax advantages.

6. THE FIRST JOINT VENTURE OF VOLKSWAGEN: SHANGHAI-VOLKSWAGEN – NEGOTIATIONS AND ESTABLISHMENT

After the 'open door policy' of Deng Xiaoping in 1978, the Chinese Ministry of Machine Building invited several foreign car manufacturers, among them Toyota, General Motors, Renault and VWAG, to negotiate the setting up of a joint venture in China for car production. Toyota, General Motors and Renault, after a short period of negotiations, did not show any interest to set up a joint venture in China estimating that if China will get their know-how, it will continue to build and sell their own cars, even abroad. Only VWAG had a different appreciation of the situation. Therefore, in 1978, a delegation of VWAG went to Beijing to get more detailed information about the intention of the Ministry of Machine Building. The Chinese part announced its intention to build 150,000 cars per year but VWAG first refused this proposal for reasons of high costs. Shortly thereafter, however, Dr. C. H. Hahn, the new CEO of VWAG, was very interested in this project and decided to immediately resume negotiations with the Chinese partners.

[19] Ladány (1994) 35.
[20] Ladány (1994) 36.
[21] Ladány (1994) 52.

VWAG resumed the negotiations with *Shanghai Tractor and Automobile Investment Corporation(STAC),* a state-owned company, as early as in spring 1979, only a few months after the enactment of the Chinese joint venture law. Later on, the *Bank of China (BOC)* and the *China National Automotive Industry Corporation (CNAIC)* joined the negotiations, CNAIC mainly in order to supervise the negotiation on State level and BOC in order to guaranty the payment of dividends to VWAG. a Trial Manufacturing Agreement was signed on April 11, 1983 as the result of these new negotiations.

At that time, the negotiation with Chinese partners were not easy as the Chinese partners, after a long isolation, were not accustomed to negotiating with foreign partners; they were traditionally suspicious about the foreign partners' sincerity and willingness to transfer the most modern technology and update them at the same time as in the home country. Only a few members of the Chinese team could speak a foreign language and the head of the Chinese team was obliged to frequently report to the authorities, at the local and national level. This, of course, delayed the negotiations. The Chinese negotiation team was generally large, frequently consisting of 10-15 or more members, mostly engineers, a few businessmen and/or accountants and often no lawyers while the VWAG negotiation team generally consisted of a team leader, an engineer, a financial expert and a lawyer. The foreign and Chinese approaches in negotiations often appeared incompatible and as a result, foreigners usually see Chinese negotiators as inefficient, indirect, and even dishonest, while Chinese see foreign negotiators as aggressive, impersonal, and excitable.

Such differences have deep cultural roots. In negotiations, the Chinese business people usually adopt different intellectual games like, e.g., *wei qi* as well as other negotiation elements, like *zhengti guannian*. *Wei qi* is a game originated in the *Zhu Dynasty* (1046-256 BC) which is played on a grid of black lines (usually 19x19). The objective of the game is to use one's stones to surround a larger total area of the board than the opponent. The Chinese *zhengti guannian* (holistic thinking) is completely different from the Western type of sequential and individualistic thinking, breaking up complex negotiation tasks into a series of smaller issues, such as price, quality, delivery, have given rise to a clearly defined set of elements that underpins the Chinese negotiation style.[22]

This set of elements is:

– *zhengti guannian* (holistic thinking)
– *shehui dengji* (social status)
– *mianzi* ('Face' or social capital)
– *zhongjian ren* (the intermediary used to influence the foreign partner)
– *guanxi* (personal connection)
– *jiejian* (thrift)
– *chiku nailao* (endurance, relentlessness, or eating bitterness and enduring labor)
– *renji hexie* (interpersonal harmony)[23]

In negotiations, Chinese partners largely use *Sun Zi*'s theory on art of war. The ancient guidance of *Sun Zi* means that the wisest posture in combat is to lay back, let one's opponent make fatal mistakes and, only then, capitalise on them. The Chinese negotiating style may be characterized by

– opening moves
– period of assessment

22 Fernandez and Underwood (2009) 183.

23 Graham and Lam (2003).

– end game
– implementation

The Author's *personal experience* is that is an *opening move* characteristic of Chinese partners is that they are quite reluctant to negotiate with lawyers and often even in presence of lawyers, probably because lawyers do not have the same reputation in China (shenhui dengji or social status)[24] as in Europe and the USA. However, this situation may have changed by now. The Chinese team, consisting of technicians, businessmen and, sometimes, officials, tried to write a *legal text with non-binding statements and vague formulations,* while refusing verbatim every pronouncement made by the Western partner. This text is then presented it years later, when the circumstances have changed, and insisted that it represented a binding promise.

The tricks employed by the Chinese negotiators do not seem any different from those employed worldwide, they have however been refined to a *ritual*. Also, a *ritualized negotiating process* can be entrusted to *middle-ranking managers* and watched and directed discretely by those in real authority who do not wish to show their hand. In this way, those in the leadership can grant *last minute concession* to save negotiations from failure, or withhold their approval – without losing face.

One of the most important tasks of the Chinese negotiators in the *opening phase* of the talks is the search for the 'right partner' (*zhongjian ren* – intermediary) among the negotiators in the foreign team. This will not necessarily be the most senior of the foreign negotiators, but the *one who seems to be forthcoming to the Chinese side.* If they find a member of the foreign delegation who is willing to talk to them and to his colleagues outside of the formal negotiations, and appears to be helpful in putting across their point of view, *they will shower him with attention and friendliness (renji hexie* – personal harmony). *The Chinese are great cultivators of friendly feelings* as they believes that friendship results in obligations. Therefore, they look for a suitable person to act as a 'right' intermediary (*guanxi* – personal connection) between the two delegations.[25]

The *place of negotiations* also plays an important role in negotiations with Chinese partners. The negotiations rarely could take place abroad because the need for the Chinese negotiators *to constantly refer to their superiors* and also because of *jiejian* (thrift). China's history of economic and political instability has namely taught its people to save money. In addition, those who have real authority may not like the contract resulting from negotiations abroad which they were not able to follow and direct on a day-to-day basis.

The Chinese location for the talks is particularly important for the *second phase* (period of assessment) where the foreign team is asked to present its ideas in more details. Such ideas are immediately communicated to the invisible persons of authority. They will then decide the line to be adopted by the Chinese negotiators, reaching their decisions based on reports from their negotiators, without discussion with the foreign party. After the main line to be taken has been *determined by those in authority,* the Chinese technique did not seem to be particularly original:

– the usual attempt off *play out members of the foreign team against each other,* the labeling of its individual members as 'good' or 'bad',

– attempts to *make the foreign partner feel guilty about delays* when opposing unacceptable demands,

– attempts to *exert pressure through the press and media,*

[24] Chapel (1998) 172.
[25] Graham and Lam (2004) 43.

It may happen that the Chinese negotiators will be so 'good' at the delaying tactics designed to tire out the foreigner that they will *put themselves under time pressure* and as result , they suddenly *forgot about all-important principles and essential details* in the rush to be able to submit the signed contract for approval as soon as possible.

In such a case, the essential details will be left out in the hurry but will come back with a vengeance and negotiations will be reopened after signatures.

In the VWAG case, the conclusion of the agreement *(end of the game)* was not yet the beginning of business as our contract was subject to approval by the appropriate authority. Only after the approval had been obtained, could the assembly of cars and production of engines could start *(implementation)*.

It is no wonder that the negotiations between VWAG and STAC, and later on with the participation of BOC and CNAIC as further partners, lasted for five years. The reasons are multiple and the difficulties in negotiation with Chinese partners has already been mentioned but in addition, there were also some political reasons. Chen Yun, then one of the most influential leaders of China, was also responsible for approval of foreign investments, intentionally delayed the approval of this contract, as reported by the former Chinese Prime Minister, Zhao Ziyang.[26] The leader of the VWAG negotiating team, Heinz Bauer, noticed that for these negotiations, 29 negotiation rounds of three weeks were needed, nine travels to China spending there 230 days there altogether, additionally, of course, to the negotiations in Wolfsburg.[27]

This Joint Venture Contract was concluded on November 10, 1984 in Beijing for the duration of 25 years, in the presence of the German Chancellor Helmut Kohl and the Secretary of the CCP and Head of the State Zhang Ziyang, between the following partners:

- Volkswagen AG (VW) 50%,
- Shanghai Tractor and Automobile Corporation (STAC) 25%
- Bank of China (BOC)15% and
- China National Automotive Industry Corporation (CNAIC) 10%.

The Joint Venture Contract contained about 500 pages including the following Appendices:

- Articles of Association,
- Technology Transfer Agreement,
- Time Schedule,
- Contributions in Kind,
- Price Fixation,
- Organizational Structure,
- Scope of Responsibility,
- Local Content Development Program,
- Lay-out and External Infrastructure,
- Feasibility Report,
- The Content of Essential Provisions of Employment Contracts for Expatriates, and
- Housing for Expatriates.

These Appendices constituted an integral part of the contract.

The joint venture under the name Shanghai-Volkswagen (SVW) started the assembly of Santana and the production of engines in 1985. At that time started also the *management*

[26] Zhao (2010) 100.

[27] Tangemann (2014).

of the joint venture. The joint venture contract regulated the *management of Shanghai-Volkswagen* in the following way:

– the highest organ of the company was the *Board of directors* (BoD) consisting of ten members, five of which, including the First Vice Chairman, were appointed by VWAG, three by STAC, including the Chairman, one by BOC to be the Second Vice Chairman, and one by SNAIC; the presence of the representatives of the trade union was compulsory though they did not have voting right,

– the board of directors had especially the following tasks:

= The appointment and revocation of the members of the *Executive Committee* (EXCOM).

= The establishment of general policy/

= The establishment of general plans for the realization of the general policy.

= The establishment of organizational structure

= The establishment of by-laws

= The establishment of product program

= The establishment of investment program

= The establishment of personnel plan. The approval of budgets and of annual reports as well as of the balance sheet, and profit and loss statements as well as

= *'all other activities the Board may deem suitable'.*

A unanimous decision was required in many of these cases.

In first stage of its activities, the EXCOM consisted of four members: Managing Director, appointed by STAC, Deputy Managing Director, appointed by VWAG and responsible for finances, purchase and sales, Technical Director, appointed by VWAG, and a Director of Human Resources who was appointed by STAC. The EXCOM was responsible

– to prepare the meetings of the BOD

– to carry out the resolutions and instructions of the BOD

– to organize and direct the daily business of the company under the – supervision of the BOD.

The by-laws of the company stipulated in detail the powers of the EXCOM.

7. MANAGEMENT OF JOINT VENTURES AND WHOLLY FOREIGN-OWNED COMPANIES

In China, the management of joint ventures and even of wholly foreign-owned companies requires Chinese management practices which are largely different from the western management styles. It is still highly influenced by *Confucianism* which is the leading factor in business practices in China.

When managing a joint venture or a wholly foreign-owned company in China, the foreign manager must take several issues into account which are, in general, different from their understanding when managing a company in western countries. Such issues are, also according to the Author's experience:

– conflict of interests
– privacy
– intellectual property rights
– management of personnel
– *guanxi*
– saving 'Face'
– legality and morality

– contract and trust, and
– the concept of *yi*

The concept of *conflict of interests* was *not known as a concept* in traditional business culture in China because it was quite common for people to do business with their friends and relatives first. When managing a joint venture or a wholly foreign-owned company in China, one must be very careful in the assessment of conflict of interest for not every conflict of interest will be – in western sense – harmful for the company.[28]

The concept of *privacy* is missing in traditional Chinese culture; there is even no direct translation in Chinese for the English word 'privacy'! Therefore, it will be self-understood that employees may know, e.g., each other's salaries.[29]

Intellectual property right is still a *hot issue* in China, though this problem is by no means a recent one. Already in the early period of the Qing Dynasty (1644–1912), when the Italian Jesuit missionary *Matteo Ricci* gave some precious clocks to the emperor *Qianlong* (1735–1796) as presents, the emperor ordered his experts to dissemble and *copy* them. The clocks were to be produced within a few days, in the *same quality* as the presents given by Matteo Ricci *under the menace of death penalty in case of failure!* Thus, *copying the best things was always worth imitation.*

In my experience too, Chinese employees prefer *clearly defined tasks* and are reluctant to acceptjobs that involve any uncertainty. However, many foreign managers do not understand such an attitude of Chinese employees and *complain* that the Chinese subordinates always ask for detailed instructions, unwilling to act at their own discretion. Refusing or even showing reluctance in carrying out orders from one's superior is viewed as *disobedience* and considered disgraceful. Therefore, due to the love for harmony in Chinese culture, *open dissent should be avoided.* Collectivism also had the effect that the Chinese tend *not to take personal responsibility.* The Chinese do not like formal rule, instead they do prefer precise orders.[30] Thus, foreign managers must be careful in dealing with Chinese personnel: they must be very precise in giving orders avoiding, at the same time, to humiliate them because then they loose their 'Face' – which is considered disastrous!

Guanxi is a special Chinese notion. It is composed by the words 'guan' meaning door and 'xi' meaning a 'department within an organization'. In the daily life, it mostly means 'personal connection' to be used at the right time and in the right place. The circle of persons with *guanxi* might be very large. The basic circle is one's family but it may include neighbors, schoolmates and other people with tight connection.[31] Of course, *guanxi* ties need to be maintained which may be done through wining and dining but also through the exchange of favors and by maintaining mutual respect and earnest friendship without any intention to harm each other. In fact, it has nothing to do anything with the perception western people may have of *guanxi* such as cronyism, nepotism, bribery, unfairness or corruption.[32]

The person of the leader such as the family father, the boss of a company, the party secretary or the head of the state is of extreme importance in the Chinese society. These persons have traditionally a patriarchal role and must therefore be respected. Since the status of the leader suggests that he shall be a morally superior person in an ideal Confucian

[28] Liu (2010) 42.
[29] Liu (2010) 20.
[30] Fernandez and Underwood (2006) 15.
[31] Liu (2010) 35.
[32] Graham and Lam (2004) 40.

world, to criticize the leader is a delicate thing to do, and it is even more difficult for the leader to acknowledge his fault. Therefore in business, people should act properly to avoid losing 'Face' or damaging the 'Face' of the counterpart. One should especially avoid criticizing the leader in public, obliging him to recognize a fault or refuse a requirement.[33]

On the other hand, some actions may enhance one's 'Face' like:

– reaching an agreement or smooth execution of the contract,

– having important people present on the signing ceremonies or other important occasions, or

– delivering favors to others.[34]

Chinese prefer *not to go to court* when they have controversy. Instead, they prefer to *negotiate* the disputed issues either among themselves or by the help of a neutral third party. The reason of this attitude is that they have a *negative attitude toward law* in general and court, in particular, because of the *predominance of criminal law* in their history. As already mentioned, also lawyers in negotiations are often considered as a burden and therefore they are only asked to join the negotiating team at the final phase of the negotiations.

Regarding the above mentioned Chinese attitude toward law, it is understandable that the *contract* was not and is neither nowadays an *indispensable* tool in doing business in China. Rather it is considered as a *record or proof* for a transaction which might be modified at any time. However, for the Chinese, if you don't trust your partner, you will not be willing to rely on a piece of paper either. If disputes arise from the contract, they should be solved in a friendly way for it is considered as *offensive to refer to the contract* because the words put on the paper some time ago *may not correspond anymore to the actual wishes and intentions of the parties.* Therefore, the Chinese do not intend to honor an agreement *unconditionally* as a primary principle and do not pay only attention to what is agreed upon but they also consider *the most sensible solution to the contract.*

The *most sensible solution* to the contract is often considered the way how to amend it when the situation changes. Therefore, many consider the *signature of a contract not as the final point of negotiations but the starting point!* The question of honoring a contract is especially important and delicate in *long term contracts* like, e.g., a joint venture contract. Here, it is essential:

– either to foresee *renegotiations* of the contract *in a specified period of time,* or

– *leave* strategically important questions *open for renegotiations at an appropriate time,* or

– *let some persons or bodies to renegotiate the contract at any time.*

The *concept of yi* can be traced back to an ancient ritual of sacrifice. It means *righteousness, correctness, justice* and *properness* and is considered as another concept of Confucianism. *Yi* is *not a set of objective rules*. It may be affected by rank of hierarchy, closeness in relationship, familial values, or 'Face'. Therefore, *Chinese culture* is often called *particularistic* because the term *yi* is referring *to what is right* and suggests universal standards, but in reality, it is actually a particularistic term which *may be interpreted case by case.* In the practice, *yi* could mean that if the contracting parties are loyal to each other, they will very well observe the correct meaning of *yi* and respect each other's specific situation. Thus, the Chinese party receiving western technology will first of all try to satisfy the foreign party's position and will not try to abuse his own situation which might be superior due to the domestic environment and, often, the authority's influence.[35]

33 Liu (2010) 67.

34 Worm (1998) 188.

35 Liu (2010) 81-82.

8. THE SECOND JOINT VENTURE OF VOLKSWAGEN: FIRST AUTOMOBILE WORKS (FAW)

In the negotiations on the first joint venture of VWAG the number of the cars to be produced per year was one of the major issues. In fact, the Chinese partners insisted that the joint venture should not produce more than 10,000 to 15,000 cars per year! In the 1980s, however, China's economic development largely allowed the production of more cars. The main Chinese automotive producer at that time was the FAW in Changchun, Jilin province, the former capital of Manchukuo, a puppet state created by Japan in 1931. This company was established in 1958 for the production of *Hong Qi* or *Red Flag,* the imitation of the Soviet product *Čajka* destined for officials only. One of the first general managers of this company was *Jiang Zemin,* at the time of our negotiations with FAW Secretary General of the CCP. But the Red Flag was an outgoing model and the Chinese officials wanted to replace it by a new model. Therefore, FAW started negotiations with VWAG and wanted to produce Audi 100. For Audi, the subsidiary of VWAG, the mother company conducted the negotiations.

The negotiations for this joint venture started in 1988 and lasted much shorter than the negotiations for Shanghai Volkswagen probably for several reasons: at that time, Chinese negotiators had already more practical experience in negotiating with foreign partners and the will of the central authorities to set up this joint venture was obviously decisive. Therefore, after two years of negotiation the Joint Venture Contract between VWAG and FAW has been signed in 1990 and the production of Jetta and Audi 100 for the Chinese market as well as the engines to be exported to Audi was started in 1991. The production volume was fixed to 150,000 cars per year.

All of the facilities in the first car plant, including the body shop, paint shop and assembly shop came together from the abandoned factory of VWAG's in Westmoreland, USA. FAW-VW started its production with the Jetta and continued later on with the Audi 100. The structure of this joint venture was the same as the one for SVW.

9. VW GROUP CHINA

Usually, foreign subsidiaries may be controlled either by the mother company or by a holding company established in the foreign country, especially when the mother company has several subsidiaries in such country. Since the enactment of the Law on Establishment of Holding Companies by Foreign Business Entities (2004), many foreign companies that have several joint ventures or wholly foreign owned companies set up holding companies.

VWAG did the same. By May 2004, it had concentrated its strength in the founding of *Volkswagen Group China* (VGC), managed by a six-member management team responsible for the areas of sales and marketing, technology, purchasing, personnel and governmental relations as well as finance. VGC's task also includes supervision of the joint ventures and wholly VW owned companies in China.

VGC, including, of course, its subsidiaries, has today 95,000 employees, has built 30 million cars (including the production of cars since 1985 by SAIC and FAW) by now at 30 Chinese production sites now, which have been sold by 5,000 dealers (with 330,000 employees). In 2016 alone, VGC has built about 4 million cars. The operating income of VGC amounted to EUR 774 million in 2009. VGC has 16 subsidiaries with SAIC and FAW, among them the following:

– Volkswagen (China) Investment Company Ltd., Beijing,
– Volkswagen Finance (China) Company Ltd., Beijing,

- Volkswagen Beijing Center Company Ltd., Beijing,
- Volkswagen FAW Platform Company Ltd. (Powertrain), Changchun,
- FAW-Volkswagen Sales Company Ltd., Changchun,
- Volkswagen FAW Engine (Dalian) Company Ltd., Dalian,
- Volkswagen Transmission (Dalian) Company Ltd., Dalian,
- Volkswagen Transmission (Shanghai) Company Ltd., Shanghai,
- Shanghai Volkswagen Powertrain Company Ltd., Shanghai,
- SAIC-Volkswagen Sales Company Ltd., Shanghai,
- Volkswagen Import Company Ltd., Tianjin,
- SITECH Dongchang Automotive Seating Technology Ltd., Dongchang,
- Volkswagen Hong Kong Ltd., Hong Kong.[36]

Besides, it has 29 production plants in China, including those of FAW-VW (four) and SAIC-VW (eight). These are the following:

- FAW-VW
  = Changchun (two plants),
  = Chengdu, and
  = Foshan,
- SAIC-VW (formally called Shanghai Volkswagen)
  = Shanghai (three plants),
  = Nanjing,
  = Yizheng,
  = Ningbo,
  = Urumqi, and
  = Changsha,
- 17 component plants, which have produced
  = components for 3,420 thousand cars and
  = 3.270 thousand engines.

VGC is now exploiting opportunities through strategic partnerships in four key areas:

- ride sharing,
- mobility club,
- car sharing,
- financial leasing, and
- Poc e-commerce.[37]

10. A NEW JOINT VENTURE WITH ANHUI JINGHUAI AUTOMOBILE CORP., LTD. (JAC)

VWAG recently launched a new joint venture with JAC for e-mobility holding 50% of the stock of the joint venture with a term of 25 years. With this project VGC is pursuing the ambitious target for the 'TOGETHER – Strategy 2025' program in China with the objective to build 400,000 e-vehicles in 2025, together with SAIC, FAW and JAC, the first e-vehicle to be built already in 2018.

[36] VW subsidiaries in China (2015) link 16.

[37] New opportunities (2016) link 17.

11. SHANGHAI VOLKSWAGEN AUTOMOTIVE COMPANY – TODAY

Recently, SVW changed its name to SAIC-VW. This is an interesting development. At the beginning of the negotiations between VWAG and its Chinese partners, VWAG insisted on the name 'Volkswagen Shanghai' for the joint venture, thus emphasizing the importance of the name of the car manufacturer. However, the Chinese partners resisted claiming that, the joint venture would be in Shanghai and therefore 'Shanghai' was to be mentioned first. Finally, the negotiating team of VWAG could persuade the board of management of VWAG to accept the Chinese point of view arguing that in the name 'Shanghai-Volkswagen' the word 'Shanghai' could be considered as a mere adjective!

In the meantime, also STAC changed its name into *Shanghai Automotive Industry Corporation* – SAIC. In 2010, the equity holdings was split and the present participation ratio is as follows:

- Shanghai Automotive Industry Corporation (SAIC) 50%,
- Volkswagen AG 40%, and
- Volkswagen (China) Investment Co., Ltd. 10%.

In the meantime the term of the Joint Venture Contract has been extended to another 45 years, now running until 2030.

Being the biggest shareholder of Shanghai-Volkswagen, SAIC recently insisted to change the name of the joint venture into *'SAIC-Volkswagen'*. VWAG accepted this proposal.

In April 2005, Škoda officially landed at SVW where they to produce its different models. The production of the first Škoda car, Octavia, started the production in June 2007, other types of Škoda followed.

By October 2009, SVW (now SAIC-VW) had turned out over five million cars in total, becoming the carmaker with the biggest population of cars in China. Its 22,000 employees are now producing the following models:

- Volkswagen:
  - = Tiguan LWB
  - = Touran
  - = Passat New Lingyu
  - = New Passat
  - = Lavida (Sedan)
  - = Grand Lavida
  - = Cross Polo
  - = Polo (Hatchback, Cross Polo, Polo GTI)
  - = Santana Vista
- Škoda:
  - = Octavia
  - = Fabia
  - = Superb
  - = Yeti, and
  - = Rapid[38]

In 2016, SAIC-VW produced 1.90 million cars.

[38] SAIC-VW models (2009) link 18.

12. FAW-VOLKSWAGEN – TODAY

In 1995, FAW, VW AG and Audi decided to integrate Audi to the product line of FAW-VW and in 1996, the first Audi 100 rolled off the line. In the same year the engine shop started running.

In 1997, FAW-Volkswagen Sales Company Ltd. was established as a joint venture between FAW-VW and the FAW Group with equity holdings of 50% for each. The participation in the company is today as follows:

- FAW Group: 60%
- Volkswagen AG: 20%
- Audi AG: 10%, and
- Volkswagen (China) Investment Co., Ltd.: 10%.

FAW-VW is actually producing the following models:

- Audi A3 Type 8V
- Audi A4L Type B9
- Audi A6L Type C7
- Audi Q3
- Audi Q5
- Volkswagen Jetta Night,
- Volkswagen Bora Mk. II
- Volkswagen C-Treck
- Volkswagen Golf Mk.VII
- Volkswagen Golf GTI Mk.VII
- Volkswagen Sagitar Mk. II
- Volkswagen Magotan Type B8L, and
- Volkswagen CC Type 35[39]

13. PRESENT SITUATION IN THE CHINESE CAR INDUSTRY

In 1985, only about 10,000 passenger cars were sold in China.[40] In 2016, VGC sold 3.98 million units (sales of the cars produced in the joint ventures of SAIC and FAW as well as imported cars), i.e., 12.2% more than in the previous year. Among these cars

- 3 million were Volkswagen,
- 591,600 Audi,
- 317,100 Škoda and
- 65,200 Porsche,

In the same year VGC made a profit of USD 5.36 billion (or 5 billion Euro).

Within the VGC, the production is constantly oriented toward the future based crossbrand production strategy. Digitalization, autonomous driving and e-mobility will fundamentally transform the automobile production of VGC. In 2020, VGC plans to produce 400,000 e-cars and 1.5 million in 2025.

In 2016, 18.68 million new cars were produced in China, more than in the USA where the car production reached ‘only’ 17.5 million. In this period, VGC produced and sold 3.026 million cars, which represent 16% of the Chinese market, thus being behind General

[39] FAW-VW models (2016) link 19.
[40] Unbegrenzter Wachstum (2015) link 20.

Motors. The latter produced and sold 3.61 million of cars in China, representing 19% of the Chinese market.

It is noteworthy that, in Beijing alone 1,200 new cars are being registered on average per day. No wonder, as today there are 6,322 companies that produce cars in China's 27 provinces (out of 31 provinces) and since 2002 about 50% of the sales went to private persons. This development is also remarkable because today there are very high taxes for the admission of new cars – up to 178,000 Euros per car depending, of course, on the acquired model.[41]

Can such an amount of cars be continued to be produced in China? On the one hand yes, because in China, there are still only 30 cars per 1,000 inhabitants while in the USA and in the EU countries there are 400-500 cars per 1,000 inhabitants. On the other hand, there are 684,000 victims per year due to air pollution. Therefore, it is planned that in 10 years China will not issue license plate for fuel and diesel cars at all.

14. OTHER ACTIVITIES OF VGC

Besides of producing cars, VGC also supports the arts, culture and sports in China e.g., the Artistic Engagement Program in order to spread cultural activities throughout China. With the 'VGC Music Night', VGC brought together the Shanghai Symphony Orchestra and students from the Shanghai Orchestra Academy with principal musicians from the German Norddeutscher Rundfunk (NDR) Philharmonie Orchester. VGC also supports the China Youth Football Training and is promoting, in general, football in China. In this context it is interesting to note that already in 1992, SVW financed a German football coach for the Chinese national team.

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Combating Unjustified Sanitary and Phytosanitary Measures in the African Tripartite Free Trade Area (SADC-EAC-COMESA): SPS-Plus or SPS-Minus?

HARRISON O. MBORI*

Abstract: Sanitary and phytosanitary measures (SPS) are incessant non-tariff barriers (NTBs) to trade in both intra and extra-African trade. New SPS measures are now set up in the African Tripartite Free Trade Area (TFTA) that amalgamate three existing regional economic communities (RECs): The Common Market for Eastern and Southern Africa (COMESA), the South African Development Community (SADC), and the East African Community (EAC).

This article compares and contrasts the SPS measures obligations as set out in Annex 15 of the TFTA to the WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement). Additionally, the application of 'abusive SPS measures based on minority science' as non-tariff trade barriers to both internal and external African trade especially on agricultural products is analysed. An increase in transparency and accountability in the formulation of NTBs monitoring mechanisms in the COMESA, SADC, and EAC would address this ever present problem. The TFTA in Annex 15 is a case of SPS-Minus as it has a number of serious shortcomings including the lack of important obligations of sufficient risk assessment, non-discrimination, equivalence, the precautionary principle, and specific reference to consultations and dispute settlement. Notwithstanding these omissions, the TFTA has the potential for great achievement in the curbing of NTBs generally and unjustified SPS measures specifically because of the monitoring, transparency, and harmonisation obligations. If the Tripartite mandate, however, turns out to be like most other 'loose' integration efforts in Africa, then there is reason to believe that the NTB monitoring and reporting mechanism is not going to bear much fruit.

Keywords: Sanitary and Phytosanitary Measures (SPS), Tripartite Free Trade Agreement (TFTA), East Africa Community (EAC), South African Development Community (SADC), Common Market for Eastern and Southern Africa (COMESA), World Trade Organization (WTO)

1. INTRODUCTION

All states have a fundamental regulatory interest in protecting their human, animal, or plant health or life.[1] This is an important and legitimate regulatory aim, at the [African] regional and domestic level but 'it rarely receives systematic and detailed attention in public debates and trade negotiations'[2] and this is especially true as Africa regional integration has been described as 'loose' and 'flexible.'[3] This important and legitimate concern (protecting human, animal, and plant health or life) has to be counterbalanced with the general liberalisation aims of international trade. This is to ensure that these regulatory aims are not used as disguised protectionist measures to international trade. Marceau and Tratchman

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1 NicShuibhne (2006) 80; *see also* Alemanno (2007) 26.

2 Wagner (2017) 445–470.

3 Gathii (2010a) 608; *see also* Helfer (2012) 175–93.

note, even with this noble aim in mind, that 'the distinction between a protectionist measure-condemned for imposing discriminatory or unjustifiable costs, and a non-protectionist measure restriction trade incidentally (and thus imposing some costs), is difficult to make.'[4] This is because 'free trade and regulatory autonomy are often at odds with each other.'[5]

'The WTO is the most universal international trade body.'[6] The World Trade Organization's (WTO) multilateral legislative function has significantly waned in recent years.[7] Focus, for both developing and developed countries, has now shifted to bilateral and regional trade agreements covering a myriad of substantive areas including investment, domestic regulation, and surprisingly, human rights.[8] Two prominent examples in Africa are the just concluded Tripartite Free Trade Area (TFTA) amalgamating three existing regional economic communities (RECs): (the Common Market for Eastern and Southern Africa (COMESA), The Southern African Development Community (SADC), and the East African Community (EAC), and the Continental Free Trade Agreement (CFTA) seeking to bring the entire continent under one umbrella free trade agreement (FTA) which is still under negotiation.

Non-Tariff Measures (NTMs) are facially neutral governmental measures that may have an impact on trade.[9] NTMs that act as prohibitions or restrictions on trade or NTMs that distort international trade without necessarily restricting it, are considered to be Non-tariff barriers to trade (NTBs).[10] The WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement)[11] and Agreement on Technical Barriers to Trade (TBT Agreement)[12] were conceived as a response to the increasing importance of NTBs that had supplanted tariffs, as barriers to trade, in successive negotiation rounds of GATT before the formation of the WTO.[13] Before the SPS Agreement entered into force, 'health regulations could only be justified once a prior violation of one of the GATT principles/obligations had been found.'[14] The two agreements mentioned above were also conceived in pursuance of maintaining an appropriate balance between protectionist measures and allowing States to maintain their regulatory autonomy.[15]

This article therefore investigates the SPS measures under the African TFTA and under the various RECs that constitute the TFTA. This analysis compares and contrasts these SPS measures to the WTO SPS Agreement. The article is divided into two broad parts. The first part an introduction to the African TFTA, describing its nature, origin, and geographic coverage. This part also discusses the legal regime on SPS measures in the Southern Africa Development Community (SADC), the East African Community (EAC), and Common

[4] Marceau and Trachtman (2002) 811.

[5] Marceau and Trachtman (2002) 811.

[6] Wagner (2012) 713; Pauwelyn (2005) 2.

[7] VanGrasstek (2013) 57.

[8] Gathii (2017b) link 21.

[9] Osiemo (2015) 176.

[10] Santana and Jackson (2012) 462, 475.

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[12] Agreement on Technical to Barriers to Trade, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, *Legal Instruments – Results of the Uruguay Round,* vol. 31, 138.

[13] Ahearn and Fergusson (2010) 3.

[14] Pauwelyn (1999a) 644.

[15] Marceau and Trachtman (2002).

Market of Eastern and Southern Africa (COMESA). The second and final part focuses on Annex 15 of the TFTA covering its SPS provisions and how they compare with the SPS provisions of the three different RECs. This part also offers recommendations and asserts that SPSs are one of the major NTBs that should be addressed in both intra and extra-Africa trade and that the measures proposed for monitoring and reporting NTBs should be more transparent and accountable to enhance their legitimacy and assist in the elimination of NTBs. It is generally argued that, due to the intertwining nature of memberships in the different RECs (spaghetti bowl), the efforts at streamlining the process of monitoring, reporting, and eradication of NTBs in intra-African trade may be compromised.

2. THE TRIPARTITE FREE TRADE AREA: FROM CAPE TOWN-TO-CAIRO

The COMESA–SADC–EAC Tripartite Free Trade Area (TFTA) amalgamates three existing Regional Economic Communities (RECs): the Eastern Africa Community (EAC),[16] the Common Market for Eastern and Southern Africa (COMESA),[17] and the Southern African Development Community (SADC).[18] The TFTA was first conceived in 2005 and the Tripartite Task Force, headed by the Secretary Generals of the three RECs have met at least twice per year since 2006.[19] On 15th June 2015, the COMESA-EAC-SADC Tripartite Free Trade Area (TFTA) was launched in the Egyptian resort of Sharm El Sheik by the 26 member States.[20] The TFTA covers a population of 632 million and a combined GDP of $ 1.3 trillion.[21] It covers an area that spans 17.3 million square kilometers; nearly twice the size of China or the United States and will represent more people than the North American Free Trade Area (NAFTA) or the European Union.[22] The overarching objective of the Tripartite Free Trade Area is to contribute to the broader objectives of the African Union

16 The Treaty Establishing the East Africa Community (EAC) was signed on 30 November 1999 and entered into force on 7 July 2000. Its original members were Kenya, Tanzania, and Uganda. Burundi and Rwanda acceded to the EAC Treaty on 18 June 2007 and became full members on 1 July 2007. The Republic of South Sudan acceded to the Treaty on 15 April 2016 and become a full Member on 15 August 2016.

17 The Common Market for Eastern and Southern Africa (COMESA) was formed on 8 December 1994. It replaced the former Preferential Trade Area (PTA) which had been in existence since 1981, with the objective of ultimately creating a larger market for greater social and economic cooperation between members and eventually resulting in a common market. The COMESA Treaty was signed on 5 November 1993 in Kampala, Uganda and later ratified on 8 December 1994. Its current members are Burundi, Comoros, the Democratic Republic of Congo (DRC), Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, South Sudan, Sudan, Swaziland, Uganda, Zambia, and Zimbabwe.

18 The Southern African Development Community (SADC) was formed in 1980 with 9 Member States, as the Southern African Development Coordination Conference (SADCC). The SADCC was formed after the adoption of the Lusaka Declaration–Southern Africa: Towards Economic Liberation– in 1980. The founding Member States were Angola, Botswana, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zambia and Zimbabwe.

19 East African Community (COMESA-EAC-SADC) Tripartite (2017) Link 6.

20 SADC, COMESA, EAC-SADC Tripartite Free Trade Area Launched, Link 15. The TFTA will stretch from Cape Town to Cairo, creating an integrated market with a combined population of almost 600 million and a total Gross Domestic Product (GDP) of about US$ 1 trillion.

21 Juma, Mageni (2017) link 2.

22 Bird (2017) link 11.

(AU) – The acceleration of economic integration of the continent and achieving sustainable development, alleviating poverty and improving the quality of life for the people of the eastern, central, and southern African Region.[23]

It is important to note that the TFTA is not an attempt to merge COMESA, SADC, and the EAC at their current integration levels.[24] It is instead intended that the already existing FTAs under the various RECs would form a wider FTA encompassing the 26 countries.

2.1 SPS Measures Existing under in SADC, EAC, and COMESA

The three RECs that form part of the TFTA had already set up their own individual SPS measures before the conclusion of the TFTA and launch them in 2015. SADC member states negotiated and adopted the SADC Trade Protocol (SACD PT) from which Annex VIII concerning Sanitary and Phytosanitary Measures was adopted. EAC member states also negotiated and adopted the EAC Protocol on Sanitary and Phytosanitary measures pursuant to Article 108 of the EAC Treaty,[25] and Article 38 of the Protocol on the Establishment of the East African Customs Union.[26] Both these provisions require the harmonisation and co-operation of the EAC member states regarding the application of SPS measures in the establishment of the EAC as an economic community and as a customs union. The COMESA member states undertook through the COMESA SPS Regulations, which were adopted as part of the legal framework of the COMESA Treaty, to implement and harmonise their SPS measures. This is the general backdrop upon which the TFTA negotiations were being undertaken about SPS measures. The biggest concern would therefore be the direct duplication, overlap, and contradiction of obligations horizontally among the RECs and vertically with the WTO SPS Agreement. SADC member states were the first to set up their SPS regime in 2000, followed by COMESA member states in 2009 and lastly EAC member states in 2016.The following section analyses more specifically the three different and separate SPS regimes and compares them to the WTO SPS Agreement.

2.1.1 An Assessment of the SADC SPS Annex VIII

The SADC Trade Protocol (SADC-PT) was passed on 24th August 1996.[27] It only came into effect on 1st September 2000 after protracted negotiations.[28] The SADC-PT, according to the SADC Treaty,[29] is 'an instrument of implementation' carrying the same legal force as the SADC treaty. The SADC-PT has the objectives of further liberalisation of intra-regional trade in goods and services; ensuring efficient production within SADC; contributing towards improvement of the climate for domestic, cross-border and foreign investment; enhancing the economic development, diversification and industrialisation of the region; and establishing a Free Trade Area (FTA) in the SADC region.[30] Article 16 of the Protocol provides the main obligations on SPS measures. SADC member states agree to

[23] East African Community (COMESA-EAC-SADC) Tripartite (2017) link 6.

[24] Kalenga (2011) link 9.

[25] The Treaty for the Establishment of the East African Community (As amended on 14th December 2006 and 20th August 2007).

[26] The Protocol on the Establishment of the East African Customs Union (2005) link 14.

[27] SADC (2017) link 15.

[28] Kalenga (2004) link 13.

[29] Treaty of the Southern African Development Community (SADC), 32 ILM 116, Article 1.

[30] Southern African Development Community, (1996), SADC Protocol on Trade¸ Article 2.

base their SPS measures on international standards, guidelines, and recommendations in order to harmonise sanitary and phytosanitary measures for agriculture and livestock production.[31] Additionally, the provision also obliges SADC member states, upon request, to enter into consultation with the aim of achieving agreements on recognition of the equivalence of specific sanitary and phytosanitary measures, in accordance with the WTO SPS Agreement.[32] The SADC SPS Annex was signed on 7th December 2012 and came into force upon approval by the SADC Committee of Ministers of Trade on 17th July 2014, in Gaborone, Botswana.[33]

It is important to note that all the member states of SADC are also members of the WTO. This means that the multilateral obligations stemming from the WTO SPS Agreement apply to them even without the more specific obligations in the SADC-PT and Annex VIII. The objectives of Annex VIII are to facilitate the protection of human, animal or plant life or health in the territory of members; to enhance the member states' implementation of the WTO SPS Agreement; to enhance technical capacity to implement and monitor SPS measures including promoting greater use of international standards and other matters concerning SPS; to provide a regional forum for addressing sanitary and phytosanitary matters and to provide a regional forum for resolving trade related sanitary and phytosanitary issues.[34] As emphasised in the second objective of the SADC-PT, the majority of provisions in the Protocol correspond directly with those in the WTO SPS Agreement. Additionally, it is important to note that Annex VIII has two appendices, the 'Transparency of Sanitary and Phytosanitary Regulations' (Appendix A) and 'Control Inspection and Approval Procedures' (Appendix B). These two appendices form an integral part of the SADC Annex and the SADC-PT on trade.[35]

The core substantive provisions of the SADC-SPS Annex are largely identical in wording and in purpose to the WTO SPS Agreement.[36] There are, however, certain specific differences and variances that might have serious legal implications. On the principle of harmonisation, the SADC member states undertook 'where appropriate' to work towards harmonisation of their respective mandatory requirements taking into account relevant international standards, guidelines or recommendations.[37] The wording here is at variance with that of the WTO SPS Agreement which requires that members 'base their sanitary or phytosanitary measures on international standards, guidelines, and recommendations.'[38] The use of the word 'taking into account relevant' international standards in the SADC-SPS is less stringent than 'based on' international standard in the WTO SPS Agreement. This is based on the WTO Appellate Body's view on the establishment of a presumption of consistency when measures are based on international standards.[39] This means that SADC member states need not base their SPS measures on international standards if they have taken into account relevant international standards. This is accurate for at least the SADC SPS standards even though all SADC members are WTO members and are therefore bound

31 SADC Protocol on Trade, Article 16(1).
32 SADC Protocol on Trade, 16(2).
33 Joubert (2014) 26.
34 SADC-PT, Article 2.
35 SADC-PT, Article 4.
36 Joubert (2014) 27.
37 SADC-SPS Annex, Article 6(1).
38 WTO SPS Agreement, Article 3(1).
39 Appellate Body Report on *EC-Hormones,* para 171.

by the higher WTO SPS Agreement standard. Additionally, SADC member states are required within the limits of their resources to make every effort to participate in relevant international organisations and, whenever possible, if mandated, to present a common SADC position in these organisations to promote within these organisations the development of periodic review of standards, guidelines, and recommendations with respect to sanitary and phytosanitary measures.[40]

The next substantive requirement is equivalence. SADC members undertake to the extent practicable, without compromising their appropriate levels of SPS protection and in accordance with guidelines developed by the WTO SPS Committee and the relevant international standard setting bodies, to enter into consultations aimed at achieving bilateral or regional agreements on the recognition of equivalence of their SPS measures.[41] This provision is more extensively worded than that of the WTO SPS Agreement.[42] Both instruments, however, use the mandatory phrase; 'shall accept' the SPS measures of other member states as equivalent. This accordingly means that members have no discretion to refuse requests of the equivalence recognition once the inspection, test, and relevant procedures have been met.[43]An objective assessment by the importing member state and the exporting member state provided the importing member state provides scientific evidence or other information, in accordance with risk assessment methodologies agreed upon by both members.[44] If an importing member state on a scientific basis determines that the exporting member state's SPS measures does not achieve the importing member's level of protection, then it may refuse to accept the SPS measures as equivalent.[45] Written reasons should be provided in case of such refusal.[46] It is important to note that the SADC-SPS obligation on equivalence should be read similarly, based on the language of Annex VIII, on the requirement of the WTO SPS Agreement that does not require 'duplication or sameness' of the measures, but 'the alternative' of the measure if objectively and scientifically proven should be acceptable.[47]

Additionally, Annex VIII also has the core substantive provisions of risk assessment and determination of the appropriate level of SPS protection.[48] In making this assessment of risk, members are required to take into account various factors including relevant scientific evidence.[49] This provision is similarly present in the WTO SPS Agreement which requires members to base their SPS measures on relevant scientific evidence as described in Article 2 and 5 of the WTO SPS Agreement. This means that the SADC members are committed to taking a science-based approach when it comes to the imposition of SPS measures. This is true, as seen above, even in the equivalence provisions. SADC members are required to base their SPS measures, on an assessment and as appropriate to the circumstance of the risk to human, animal and plant life or health.[50] These risk assessment, like that in the WTO

40 SADC-SPS Annex, Article 6(2).
41 SADC-SPS Annex, Article 7(1).
42 *Compare* SADC-SPS Annex, Article 7(2) to WTO SPS Agreement, Article 4.
43 Landwehr (2007) 433.
44 SADC-SPS Annex, Article 7(2) (a).
45 SADC-SPS Annex, Article 7(2) (b).
46 SADC-SPS Annex, Article 7(2) (c).
47 SPS Committee (2004) 1.
48 SADC-SPS Annex, Article 8.
49 SADC SPS Annex, Article 8(2).
50 SADC SPS Annex, Article 8(2).

SPS Agreement, should 'be based on scientific principles.'[51] Furthermore, SADC members have undertaken to follow international standards in developing their SPS measures.[52] Importantly, Annex VIII embodies the precautionary principle. SADC member states can depart from the strictures of risk assessment, when such a member state determines that the available relevant scientific evidence or other information is insufficient to complete the assessment.[53] Such a member state may adopt a provisional SPS measure on the basis of available relevant information including from international standardising organizations and from SPS measures of other member states.[54]

Another key feature in the regulation of SPS measures is the precautionary principle. The principle made its first appearance in 1992 in environmental law under Principle 15 of the Rio Declaration.[55] In international trade, the principle was introduced in Article 5.7 of the SPS Agreement as a component of risk management.[56] The precautionary principle is important where parties are unable to make an objective risk assessment, thus striking a balance between international trade liberalisation and public health protection.[57] It has the effect of allowing members to maintain provisional SPS measures where the relevant scientific evidence is insufficient.[58] Thus, a positive action, such as a ban, may be adopted before the existence of a risk is scientifically established.[59] The provisional measure must be adopted on the basis of relevant information.[60] The provision on precautionary principle under the SADC SPS Annex corresponds almost directly to the WTO SPS Agreement provision on the same. The purpose of the provision is the same while the wording is slightly different. The SADC SPS allows parties to maintain a provisional measure, on the basis of available relevant information, in cases where there is insufficient scientific information to conduct a risk assessment.[61] There is a further requirement that members should, while applying the provisional measure, seek to obtain the additional information necessary to conduct an objective risk assessment.[62] They are also required to review the provisional measure within a reasonable period of time.[63] The similarity of this provision with the WTO SPS provision on the precautionary principle prevents any contradiction on the responsibilities of Member States according to the SADC SPS Annex and the WTO SPS Agreement. It instead has the requirement of streamlining regulation of SPS measures within the SADC SPS regime and the WTO SPS regime.

Furthermore, special and differential treatment is a principle that seeks to take into account the unique needs of developing and least developing countries, granting them favourable treatment in trade so as to increase their capacity to participate in in the global trading system.[64] It aims to ensure that developing and least developing countries

[51] SADC SPS Annex, Article 8(2); *compare* WTO SPS Agreement, Article 5(1) & (2).
[52] SADC SPS Annex, Article 8(1).
[53] SADC SPS Annex, Article 8(1), Article 8(3); *compare* WTO SPS Agreement, Article 5(7).
[54] SADC SPS Annex, Article 8(3).
[55] Laowonsiri (2010) 569.
[56] Laowonsiri (2010) 569.
[57] Laowonsiri (2010) 567.
[58] SADC SPS Annex, Article 8 (3); WTO SPS Agreement, Article 5 (7).
[59] SADC SPS Annex, Article 8 (3); WTO SPS Agreement, Article 5 (7).
[60] SADC SPS Annex, Article 8 (3).
[61] SADC SPS Annex, Article 8 (3).
[62] SADC SPS Annex, Article 8 (3).
[63] SADC SPS Annex, Article 8 (3).
[64] Brennan (2011) 143.

participate on a proportionately beneficial basis by going beyond formal guarantees of equality.[65] Special and differential treatment is not limited to tariffs but also extends to non-tariff issues such as extended time-frames of implementation, exemptions and flexibility from certain rules and technical assistance.[66] The WTO SPS Agreement provides for special and differential treatment in favour of developing countries and least-developed countries (LDCs). It includes, under certain circumstances, longer time-frames for compliance, time-limited exceptions from the obligations of the Agreement and facilitation of developing country participation in the work of the relevant international organisations.[67] The participation of developing and least develop countries in the work of relevant international organisations is to ensure that there is equality and broader representation of their needs and interests within these international organisations.[68] The WTO SPS Agreement also provides for technical assistance to Members, especially developing country Members.[69] The SADC SPS Annex, unlike the WTO SPS Agreement, has no provisions on special and differential treatment. This could be due to the members of SADC being either developing or least developed countries themselves or special or differential obligations were never negotiated by the least developed of SADC member states. The SADC SPS Annex, however, makes provisions for technical assistance to enhance the capacity of Member States to implement and monitor sanitary and phytosanitary measures.[70] Resource mobilisation for technical assistance under the SADC SPS Annex is a mandate to be facilitated by the SADC Secretariat working together with the SADC Sanitary and Phytosanitary Coordinating Committee. The WTO SPS Agreement, unlike the SADC SPS Annex, mandates the Members themselves to facilitate resource mobilisation for technical assistance.[71]

In an effort to ensure transparency of sanitary and phytosanitary measures, the SADC SPS Annex requires each Member State to ensure that a WTO SPS Enquiry Point exists.[72] The enquiry point has the mandate of providing answers to all questions from interested Member States on matters SPS.[73] The WTO SPS Agreement similarly requires the establishment of enquiry points to achieve the same mandate.[74] The recognition of the WTO SPS Enquiry Point by the SADC SPS Annex is important as it defeats the possibility of dual institutions conducting the same functions. Angola, Botswana, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe have established national notification and enquiry points.[75] The SADC SPS Annex does not mandate Member States to establish new enquiry points. Instead, it recognises the WTO SPS Enquiry Points and seeks to harmonise the functions between the different agreements. Closely related to the management of SPS measures is

[65] Brennan (2011) 143.
[66] Committee on Trade and Development (2001).
[67] SADC SPS Annex, Article 10.
[68] Seibert-Fohr (2007) 510.
[69] SADC SPS Annex, Article 9.
[70] SADC SPS Annex, Article 12.
[71] WTO SPS Agreement, Article 9.
[72] SADC SPS Annex Appendix A, Article 3.
[73] SADC SPS Annex Appendix A, Article 3.
[74] Article 3, Annex B, WTO SPS Agreement.
[75] Gebrehwet, Ngqangweni and Kirsten (2007) 1.

the SPS Committee. The WTO SPS Agreement establishes the Committee on Sanitary and Phytosanitary Measures (SPS Committee) to act as the main administration unit of the Agreement to oversee its implementation.[76] The SPS Committee is a regular forum at the WTO where member States and governments with observer status can conduct consultations about SPS measures that affect trade to oversee the implementation of the WTO SPS Agreement. Article 14 of the SADC SPS Annex establishes the SADC Sanitary and Phytosanitary Coordinating Committee. It also requires each member state to establish a National Committee on Sanitary and Phytosanitary measures.[77] The SADC SPS Coordinating Committee then compromises of two representatives of each National Committee on Sanitary and Phytosanitary Measures.[78] The SADC SPS Coordinating Committee acts as a consultative forum for promoting the objectives of the SADC SPS Annex and strengthening cooperation between regulatory agencies.[79] It is also mandated to promote transparency in SPS measures.[80]

2.1.2 An Assessment of the East African Community Sanitary & Phytosanitary Measures Protocol

The EAC has a current membership of 6 partner states, with the latest entrant being South Sudan. Article 5(2) of the Treaty establishing the East African Community states that the first stage of EAC integration will be the formation of a customs union.[81] The EAC Customs Union Protocol came into force in January 2005. The Protocol has four major elements within its primary objective of facilitating intra and inter African trade, the fourth of which is the elimination of non-tariff barriers (NTBs).[82] Article 38 of the Customs Union Protocol requires partner states to take cognizance of cooperation in sanitary and phytosanitary measures in order to facilitate trade in the community and among other trading partners.[83] The legal basis for the EAC SPS Protocol was also derived from the EAC Common Market Protocol in Article 5(2) (a),[84] which requires that the partner states are to harmonise and mutually recognise SPS standards and technical barriers to trade. The East African Communities Sanitary and Phytosanitary Measures Protocol that entered into force on 12th July 2013, provides the legal basis for reforms in the EAC that are to guarantee food safety, plant protection and animal health.[85] The Protocol came about pursuant to Article 151[86] of the EAC treaty that states that partner states may conclude such protocols as may be necessary for the area of cooperation and Articles 105 to 110 of the EAC Treaty which provides for partner states to cooperate in agriculture and food safety.

[76] Gebrehwet, Ngqangweni and Kirsten (2007) 1. WTO Sanitary and Phytosanitary Agreement (1995), Article 12. The SPS Committee has been involved in the reviewing of the SPS Agreement since its inception.

[77] SADC SPS Annex, Article 14 (2).

[78] SADC SPS Annex, Article 14 (1).

[79] SADC SPS Annex, Article 14 (5).

[80] SADC SPS Annex, Article 14 (4).

[81] Treaty establishing the East African Community, Amended (2007), Article 5(2).

[82] East African Community Customs Union Protocol, 2005.

[83] East African Customs Union Protocol, 2005, Article 38.

[84] East African Community Common Market Protocol, 2010, Article 5(2) (a).

[85] Kenya's Ratification (2016) link 10.

[86] Treaty establishing the East African Community, Amended (2007), Article 151.

A reading of the objectives of the EAC Sanitary and Phytosanitary Protocol ('The EAC SPS Protocol') leads to a *prima facie* conclusion that it largely mirrors the WTO SPS Agreement, in that most of its provisions are borrowed lock, stock, and barrel from the WTO SPS agreement.[87] The preamble of the EAC SPS Protocol takes note of the principle of harmonisation, for the improvement of human, animal and plant health life; the importance of the security and safety and free trade in agricultural products and, most importantly, the importance of maintaining international standards and guidelines in the formulation of SPS regulations.[88] The EAC SPS Protocol is primarily similar to the provisions of the WTO SPS agreement and serves in many areas such as risk mitigation, transparency, coordination and harmonisation of laws to bring to life the provisions of the SPS Agreement. This is in the exception of some of the principles such as non-discrimination, equivalence and risk assessment that have not been adequately addressed in the EAC SPS Protocol.[89] The Protocol is, however, substantially in conformity with the provisions of the WTO SPS Agreement and that it serves to guarantee of better food safety measures; mitigation of risks from pests and diseases and improved competitiveness of produce of the EAC in relation to external markets.[90] The EAC has been known to have focused its efforts to harmonise SPS measures and common interests through various working groups.[91]

The WTO SPS Agreement, amongst other things, enunciates the principles of nondiscrimination, transparency, harmonisation of laws and regulations, international standards and special and differential treatment to developing countries.[92] It is to be noted that all of the members of the EAC, except South Sudan, are also members of the WTO and therefore are bound to the provisions of the WTO SPS Agreement. It is recognised, however, that even though the WTO SPS Agreement was an attempt to have a harmonized multilateral system of SPS measures, it noted in its preamble that these measures are often applied on the basis of bilateral agreements or protocols. The only given caveat is that when members apply measures to protect their animal plant health or food safety, that these should not constitute arbitrary or unjustifiable discrimination or disguised restriction on international trade.[93]

Article 2 of the EAC SPS Protocol to begin with, describes its objectives as promoting trade of food and agricultural products within the community through the implementation on principles of harmonisation, transparency, risk assessment, and strengthening the coordination of SPS measures and activities at a national and regional level within the community.[94] In this, it is stated that partner states shall cooperate in the harmonisation of laws and regulations. This part is in line with Article 3 of the WTO SPS Agreement[95] which provides for harmonisation. Here, the SPS Agreement requires that the members base their SPS recommendations on international standards and guidelines as widely as possible. It should be noted that the provisions of the EAC SPS Protocol do not expressly

[87] USAID (2016).
[88] East African Community Sanitary and Phytosanitary Measures Protocol (2013) Preamble.
[89] Prévost (2010).
[90] East Africa Trade and Investment Hub (2016) link 7.
[91] Magalhães (2010).
[92] WTO Sanitary and Phytosanitary Agreement (1995) Preamble.
[93] WTO SPS Agreement (1995) Preamble; Article 1.
[94] East African Community Sanitary and Phytosanitary Measures Protocol (2013) Article 2.
[95] WTO SPS Agreement (1995) Article 3.

include the important aspect of basing the laws and regulations on international standards, but only states that the approach to be used shall be science-based and that there shall be a common understanding between the parties.[96] This is seen, according to the author, as a significant shortfall, in that even though the requirement of harmonisation is present, it is not expressly stated in the language given in the WTO SPS Agreement which seems to be more wide-ranging.

Article 4[97] which discusses plant health, states that the partner states are to among other things, harmonise the inspection of certification procedures of plant and plant products, regulate the development and use of modified organisms and products of biological modification, provide a framework for management, build systems for surveillance in pest risk analysis, designation of pest-free areas and the areas of low prevalence and harmonise import and export procedures which include the registration and identification of plant and plant products.[98] This part is seen predominantly to be in conformity with Articles 3, 5, 6, and 8 of the WTO SPS Agreement; however, it should be noted that the prospects of risk assessment (Article 5) have not been adequately laid out in the EAC SPS Protocol as extensively as they have in the WTO SPS Agreement.[99] Article 5 requires that the SPS measures be based on assessment of the risks to human, animal and plant health life based on assessment techniques in international standards and in cognizance of economic factors and scientific evidence.[100] The provisions of the EAC SPS Protocol are therefore seen as somewhat of a shortfall, especially because it is only noted that there shall be surveillance in risk analysis. There is no mention as to whether risk assessment shall be pegged on scientific evidence – an issue that has been substantially controversial in this topic.[101]

On matters of animal health, Article 5 posits that the partner states shall provide prompt and transparent notification of the existence of animal diseases, including the sharing of information on the trade sensitive diseases as well as the identification of infected zones.[102] It further goes to state in Article 5(2) (b) that there shall be the harmonisation of the inspection, certification and approval of butcheries, feed centres, dairies, animal products and feed stuff.[103] It demands amongst others, that there be a standardisation of sanitary documents including import tariffs and veterinary certificates and similar to that in plant health, it requires a harmonisation of systems for registration, identification and traceability of animals and animal products. This part is in conformity to the WTO SPS Agreement provisions in Article 3, 6, 7 and 8. Article 7 of the SPS Agreement states that members shall notify all others of any changes in their SPS measures. The EAC SPS protocol stresses that there should be the sharing of information which is also in accordance with Article 9 of the WTO SPS Agreement on the sharing of information.

[96] Magalhães (2012) 12.
[97] East African Community Sanitary and Phytosanitary Measures Protocol (2013) Article 4.
[98] East African Community Sanitary and Phytosanitary Measures Protocol (2013) Article 4.
[99] WTO SPS Agreement (1995) Article 5.
[100] Magalhães (2012) 12.
[101] East Africa Trade and Investment Hub (2016) link 7.
[102] East African Community Sanitary and Phytosanitary Measures Protocol (2013) Article 5.
[103] East African Community Sanitary and Phytosanitary Measures Protocol (2013) Article 5 (2) (b).

The provisions of Article 6 speak of food safety stipulating that partner states shall harmonize food inspection, certification and approval procedures, safety requirements for food coming from genetically modified organisms, surveillance systems for food-borne hazards in the community, import requirements and food traceability systems. There should also be the harmonisation of the determination of tolerance levels for additives, contaminants and toxins. The provisions of this part are also predominantly in conformity to Articles 3, 6, 7 and 8 of the WTO SPS Agreement and once again go to show that the principle of harmonisation has been adequately catered for in the EAC SPS Agreement.

The other provisions of the agreement stipulate other important principles stipulated in the WTO SPS Agreement.[104] In Article 7, Partner states are to designate competent authorities for the purposes of the protocol, while Article 8 elaborates extensively on Border Posts Control. Here, the protocol provides that there shall be the smooth movement of food and agricultural commodities within the region, joint inspection and clearance of food and agricultural commodities.[105] Article 8 of the WTO SPS agreement speaks of control, inspection and approval procedures and primarily posits that the members shall ensure that their procedures are consistent with Annex C to the Agreement and with all the provisions of the agreement.

In accordance with the SPS Agreement provisions on sharing of information, the protocol provides in Article 9[106] that there shall be cooperation of the sharing of information and expertise on SPS measures through the establishment of a regional information management system and that the states shall also jointly seek technical assistance in this and this is in accordance to Article 9 of the WTO SPS Agreement.[107] Most importantly, Article 11 then requires that the partner states harmonise their policies, laws and programs, which is in line with Article 3 of the WTO SPS Agreement.[108]

On dispute settlement, Article 14 states that any disputes arising between the parties should be settled in accordance with the provisions of the EAC treaty. Article 11 of the WTO SPS Agreement, although noting that Articles XXII and XXIII of the GATT 1994 apply in disputes under the agreement, states in 11(3) that nothing shall impair the rights of members under other international agreements.[109] It is to be noted that the provisions of dispute settlement may be confusing in some way, as alluded to by Magalhães, who argues that the redrafting of some of the articles of the WTO SPS Agreement may lead to confusion for instance in Article 14 on dispute settlement.[110]

As seen under the SADC SPS regime, the provisions on Special and Differential Treatment are notably absent under the EAC SPS Protocol.[111] This can, however, be partly explained by the fact that the EAC is entirely made up of developing and least developing states, which are deemed to be on the same level of development according to a 2014 report by UNCTAD.[112] This, however, begs the question what recourse a state such as South

[104] These are such as the sharing of information, inspection procedures of the various animal/plant health life and dispute settlement among others.

[105] East African Community Sanitary and Phytosanitary Measures Protocol (2013) Article 7.

[106] East African Community Sanitary and Phytosanitary Measures Protocol (2013).

[107] East African Community Sanitary and Phytosanitary Measures Protocol (2013), See Article 9; Magalhães (2012).

[108] East African Community Sanitary and Phytosanitary Measures Protocol, 2013, Article 11.

[109] WTO SPS Agreement (1995) Article 11(3).

[110] Magalhães (2010) 13.

[111] WTO SPS Agreement (1995) Article 10.

[112] UNCTAD (2014) 146.

Sudan would have since it is classified as a least developed country.[113] Article 10 of the WTO SPS Agreement states that members shall take into account the needs of developing and least developed members among them in the application and preparation of SPS measures. In this, for instance, longer time frames for compliance should be accorded to such partner states to maintain opportunities for their exports.[114] The EAC SPS Protocol does not have anything in relation to special and differential treatment; this can be arguably seen as a shortfall.

2.1.3 An Assessment of COMESA SPS Measures

COMESA, as of October 2017, has nineteen member states.[115] It is important to note that this membership does not include the Republic of South Africa and the Republic of Botswana, the two hegemons in Southern Africa. Somalia in the East is also not a member of COMESA. Additionally, among the COMESA member states, the following are not member states of the WTO: The Union of Comoros,[116] Eritrea, Ethiopia, Libya, and Sudan and despite their nonmembership, Ethiopia, Sudan, and Libya are observer governments in the WTO.[117]

Article 10 of the Treaty establishing the Common Market for Eastern & Southern Africa (COMESA Treaty)[118] vests the COMESA Council of Ministers[119] with the power to make regulations, issue directives, take decisions and make recommendations or deliver opinions. The provision goes further to stipulate that a regulation shall be binding on all the member states in its entirety, a directive shall be binding upon each member state to which it is addressed as the result to be achieved but not as to the means of achieving it, a decision shall be binding upon those to whom it is addressed, and a recommendation and an opinion shall have no binding force.[120] The meaning of the absolute binding nature of COMESA regulations has been clarified by the Legal Office of COMESA Secretariat as:

> 'As for what it means when it says 'a regulation shall be binding in its entirety', it simply means that all provisions of the regulation are mandatory and Member States are required to comply with them. It also means that a regulation is directly applicable and a Member State using its own procedures has to ensure that it is domesticated. In some countries it does not need to be ratified. In some countries it needs to be ratified as a matter of course since it is already binding on the Member States by virtue of the Authority of the Treaty'[121]

113 Prévost (2010).

114 WTO SPS Agreement (1995) Article 10.

115 COMESA (2017) link 4.

116 The Union of Comoros is, however, in the process of acceding to the WTO and intends to complete the process by MC11 in December 2017 in Buenos Aires Argentina.

117 WTO (2017) link 22.

118 Treaty establishing the Common Market for Eastern & Southern Africa 33 ILM 1067 (1994) (COMESA Treaty).

119 The Council of Ministers is established under Article 7 of the COMESA treaty together with the COMESA Authority, the Court of Justice, the Committee of Governors of Central Banks, the Intergovernmental Committee, the Technical Committee, the Secretariat, and the Consultative Committee.

120 COMESA Treaty, Article 10(2), (3), (4), & (5).

121 Ravelomanantsoa (2012).

2.1.3.1 The COMESA SPS Regulations

The Regulations on the Application of Sanitary and Phytosanitary Measures (the 'COMESA SPS Regulations') were adopted by the COMESA Council and entered into force on 9th December 2009.[122] The COMESA SPS Regulations adopt the definitions in Annex A of the WTO SPS Agreement unless otherwise required by the context of the agreement.[123] COMESA SPS Regulations have three main objectives: To set out the principles and create mechanisms for cooperation in the implementation of the SPS measures by member states; the general protection of human or animal life (sanitary measures) or health or plant life or health (phytosanitary measures) from various risks, and to ensure that the application of the SPS measures does not unnecessarily hinder trade in food and agricultural products in the Common Market.[124] These aims and objectives are similar to the general aims that are sought in the domestic and international regime when striking a balance between free trade and health protection. The Regulations, therefore, just like the WTO SPS Agreement, seek to strike that coveted 'negotiated balance between the competing goals of the liberalisation of trade in the food and agricultural sector and the protection of health by national governments.[125]

In this analysis, it is important to note that all the COMESA member states are either developing states or least developing states.[126] Therefore, there must be concern about the development dimension on meeting the objectives set out in the COMESA SPS Regulations. Developing and least developing countries bear a huge brunt when it comes to the innocuous application of SPS measures.[127]

On the application of the COMESA Regulations, member states have the right to take SPS measures necessary for the protection of human, animal or plant life or health provided that such measures are not inconsistent with the Regulations.[128] This provision is a direct borrowing of the language in the WTO SPS Agreement.[129] The Regulations introduce some of the main substantive commitments in terms of SPS by requiring that member states ensure that SPS measures are only applied to the extent necessary to protect human, animal or plant life or health, and are based on scientific principles and not maintained without sufficient scientific evidence.[130] Additionally, member states commit to avoid taking any arbitrary or unjustified measures which could result in discrimination or disguised restriction on regional or international trade.[131] These provisions, however, have the caveat in Regulation 5 on the use of the precautionary principle. There is also a direct transplantation of the language in the WTO SPS Agreement.[132] This consequently means that the sufficiency of scientific standards required in the WTO SPS Agreement and the exception in the nature of the precautionary principle is applicable under the COMESA SPS Regulations.

122 Regulations on the Application of Sanitary and Phytosanitary Measures, COMESA Legal Notice No. 310 of 2009, Official Gazette, Vol. 15, No. 5, 8 December 2009.

123 COMESA SPS Regulations, Regulation 1.

124 COMESA SPS Regulations, Regulation 2.

125 Paul (2003) 284–340, 339–40.

126 UNCTAD (2017a) link 19; UNCTAD (2017b) link 20.

127 Otsuki, Wilson and Sewadeh (2001) 495; Henson and Rupert (2001) 85.

128 COMESA SPS Regulations, Regulation 4(1).

129 WTO SPS Agreement, Article 2(1).

130 COMESA SPS Regulations, Regulation 4(2).

131 COMESA SPS Regulations, Regulation 4(3).

132 WTO SPS Agreement, Article 2(2) & 5(7).

From this, it can been seen that the tool proposed under the WTO SPS Agreement and the COMESA SPS Regulations to distinguish between measures that aim at health protection and those that are a disguised form of protectionism is science.[133] This principle, as shown here, is embedded in the WTO SPS Agreement. 'The first mention of scientific disciplines in the SPS Agreement is found in the second and third prongs of Article 2.2, which require that SPS measures be based on scientific principles and not be maintained without sufficient scientific evidence, except as provided for in Article 5.7.'[134] Interestingly, the finest example of the imposition of SPS measures not sufficiently based on scientific standards involves a COMESA member state. These are the European Communities' (EC) (now European Union (EU)) measures targeted on Kenyan fish. From 1997 the EC enacted a series of measures against Kenyan fish. 'The measures included new testing requirements and bans as a precautionary response to the outbreak of cholera in Mozambique, Kenya, Uganda, and Tanzania[135] and due to the EC's suspicion that Kenyan fishermen were using pesticide chemicals to catch fish by poisoning them.'[136] 'The EC ban was extended for a long period despite the absence of detectable chemical residues in the Kenyan fish exports and the statements by Food and Agriculture Organization (FAO) and the World Health Organization (WHO) that the risk of transmission of cholera from commercially imported fish was negligible.'[137]

Additionally, Regulation 6 of the COMESA SPS Regulations provides that member states shall comply with Articles 3 to 8 of the WTO SPS Agreement. This means 'the harmonisation obligation', 'equivalence', 'risk assessment and determination of appropriate of level of sanitary or phytosanitary protection', 'adaptation to regional conditions, including pest or disease free areas and areas of low pest or disease prevalence', 'transparency and control, inspection and approval procedures.' will be applied in the COMESA region. The interpretation offered by the WTO Dispute Settlement Body (DSB) can also be applied in the case of COMESA. The fundamental obligation of basing SPS measures on scientific standards has been underlined in *EC–Hormones* by the WTO Appellate Body (AB):

> 'The requirements of a risk assessment under Article 5.1, as well as of 'sufficient scientific evidence' under Article 2.2, are essential for the maintenance of the delicate and carefully negotiated balance in the SPS Agreement between the shared, but sometimes competing, interests of promoting international trade and of protecting the life and health of human beings.'[138]

The legal implication of the transplantation of the WTO SPS obligations to all COMESA member states is that the multilateral obligations are now made regionally mandatory. This can only be said to be SPS plus when considering that at least five-member states (Comoros, Ethiopia, Libya, Seychelles, Sudan, and Eritrea) of COMESA are not WTO member states. These countries will have multilateral standards apply to them due to their COMESA membership. This is an SPS Plus implication only when considered from

133 Prévost (2009) 587.
134 Prévost (2009) 587.
135 Committee on Sanitary and Phytosanitary Measures (1998).
136 Abila (2003); Henson and Mitullah (2004).
137 Prévost (2009) 588.
138 Appellate Body Report, *EC–Hormones,* para. 177.

the vantage point of other WTO membership. The obligations in the COMESA SPS Regulations cannot be applied by other WTO members against the non-WTO members but the fact that the non-WTO members in COMESA are bound by WTO international standards is a huge plus.

Moreover, the COMESA SPS Regulations[139] also provide an avenue of dealing with the inherent scientific uncertainty in scientific inquiries, just like the WTO SPS Agreement.[140] This is the now infamous precautionary principle. 'At the core of the precautionary principle lies the notion of scientific uncertainty in situations where action or inaction appears warranted based on the threat of serious or irreversible damage.'[141] Prof Wagner defines the precautionary principle in the following terms:

> 'The precautionary principle is not applicable in situations where sufficient scientific data is available to make rational decisions in the presence of uncertainty. It is also not supportive of a choice to be more risk averse than implied in an international standard. Rather, if it is to be both meaningful and applicable in the context of international trade, the precautionary principle can only be applicable in situations in which scientific information is not available or not available in sufficient detail in order to make a decision. To put it another way: the precautionary principle is a tool for decision-making in the absence of scientific evidence.'[142]

2.1.3.2 The COMESA Green Pass Certification (GPC) Scheme

The most important innovation of the COMESA SPS Regulations is the establishment of the COMESA Green Pass Certification (GPC) scheme.[143] This scheme sets the COMESA SPS Regulations as an example SPS-Plus regime. This does not mean that the GPC scheme lacks discrepancies as it is a commodity-specific SPS certification scheme and authority for movement of food and agricultural products within the Common market, issued by a National Green Pass Authority.[144] The objectives of the Green Pass scheme is twofold: To facilitate movement and trade in food and agricultural commodities; and to protect human, animal, and plant health or life, and the socio-economic structures and institutions of member states.[145] The incorporation by reference of the SPS definition in Annex A of the WTO Agreement in the COMESA SPS Regulations and the goal and purpose of the Green Pass Certification Scheme (as stated above) means that it can be asserted that the COMESA Green Pass Certification Scheme is intended to be a certification scheme for the combating of unjustified SPS measures that affect international trade among the COMESA member states. Ravelomanantsoa argues that the GPC scheme is intended as a SPS measure[146] as it would be more accurate to call it a regional SPS measure set to combat the arbitrary imposition of SPS measures that affect international trade.

Additionally, where a member state applies to an authority to issue a Green Pass for a commodity or group of commodities but fails to meet the stipulated requirements for the

139 COMESA SPS Regulations, Regulation 5 (Interim measures).
140 WTO SPS Agreement, Article 5(7).
141 Wagner (2012) 718.
142 Wagner (2012) 720.
143 COMESA SPS Regulations, Regulation 7.
144 COMESA SPS Regulations, Regulation 7.
145 COMESA SPS Regulations, Regulation 8.
146 Ravelomanantsoa (2012) 21.

commodity or group of commodities, the Secretariat may assist the member state to formulate a programme of interventions and source funds to address the specific deficiencies observed.[147]

An enterprise can be registered under Regulation 10(b) where it satisfies the SPS requirements as required for the commodity in question in the specific Council regulations, directives and codes of practice issued in accordance with Regulation 18.[148] Regulation 18 has provisions for mutual support and cooperation among member states.[149]

A reading of 'regulations 7, 8, 10, and 12 of the COMESA SPS Regulations show that the GPC Scheme is a SPS measure which would be a sanitary or a phytosanitary certificate issued by a National Green Pass Authority to exclusively registered enterprises for the movement of specified food and other agricultural commodities within the Common Market.'[150] This can be interpreted to be a harmonisation measure in the COMESA region that endeavours to create a single SPS regulatory regime among COMESA member states. The criteria for certification under the GPC scheme are like that of imposition of SPS measures under the WTO agreement due to the similarity of requirements in the COMESA Regulations to the WTO SPS agreement. There must be science-based measures and internationally-recognised standards for commodies and enterprises to be certified. The precautionary principle can also be applied in situations where there is scientific uncertainty.

Finally, there are many inconsistencies of the COMESA Regulations with the WTO SPS agreement that should be highlighted. Paragraph 4 of the COMESA Regulations preamble recognises the crucial harmonising role to be played by international bodies, including the Codex Alimentarius Commission (Codex), the World Organisation for Animal Health (OIE) and relevant international and regional organisations operating within the framework of the International Plant Protection Convention and *any other* organisation relevant to SPS measures. This is a blanket opening up of the COMESA Regulations, unlike the WTO Agreement, which tasks the SPS Committee with developing procedures to monitor the process of international harmonisation and coordination.[151] The definitions within the COMESA Regulations omit the last limb of the WTO SPS Agreement on any 'measure applied to prevent or limit other damage within the territory of the Member from the entry, establishment or spread of pests'[152] and replaces it with ensuring the protection of member states 'from the socio-economic structures and institutions of a Member State from

147 COMESA SPS Regulations, Regulation 11(2).

148 COMESA SPS, Regulation 12(1).

149 These includes the harmonisation of national legislation in relation to SPS measures; the development of codes of practice, guidelines and procedures on SPS measures, including procedures for monitoring, surveillance, emergency preparedness, traceability, control, inspection approval, laboratory testing and management, certification and accreditation; the establishment of appropriate coordinating mechanisms amongst recognised national SPS institutions; areas of processing technologies, diagnosis, research and infrastructure, including the establishment and upgrading of national regulatory bodies or national or regional SPS related facilities; training and capacity building at the national and regional levels; the establishment and implementation of the necessary mechanisms for monitoring and surveillance, emergency preparedness and traceability of human food-borne illness and zoonoses, as well as, animal and plant pests and diseases; the establishment of an early warning system to enhance national and regional emergency response capacity and (matters of bio-safety as provided for under the relevant international conventions and protocols.

150 Ravelomanantsoa (2012) 22.

151 WTO SPS Agreement, Article 3(5).

152 WTO SPS Agreement, Annex A.

risks arising from the entry, establishment and spread of pests and diseases'.[153] Magalhães argues that this change weakens the COMESA Regulation's protection.[154] Regulation 5, paragraph 1 of the COMESA Regulations embodies the all-important precautionary principle. It excludes the term *'relevant scientific evidence'* used in the WTO SPS Agreement[155] and instead uses *'sufficient scientific information'*. This change of terminology has the potential of dangerously undermining WTO rights and obligations of member states.[156] Under Regulation 23 of the COMESA Regulations, the dispute resolution process is different from that of the WTO DSB. The regulations do not mention the relationship between the dispute resolution process prescribed in the regulation i.e., consultations, if the consultations fail in 60 days a committee resolution is proffered, where a member is not satisfied with the committee resolution the member can submit the dispute to the COMESA Court of Justice for binding arbitration under Article 28 of the COMESA Treaty, and the WTO DSB process. This omission might cause inconsistencies when it comes to whether the COMESA dispute resolution process takes precedence over the WTO DSB.

2.2 Comparisons between COMESA-EAC-SADC SPS Annexes

At a glance, the COMESA, EAC and SADC Instruments on SPS measures are complimentary as they each have the objective of regulating SPS. Each Instrument seeks to strike a balance between the protection of plant, animal and human health or life while at the same time pursuing the objective of trade liberalization. However, a close examination reveals that there are challenges and opportunities that must be explored particularly in the process of gearing up towards that TFTA and eventually the CFTA.[157]

One of the main challenges is to avoid overlap, duplication and contradiction in relation to the WTO SPS Agreement and SPS regimes of the different RECs. COMESA, EAC, and SADC SPS regimes are based on the text of the WTO SPS Agreement and draw considerably from the text of the Agreement.[158] This practice of repeating, restating in part, and rephrasing selected parts of the texts of the WTO SPS Agreement leads to a situation where important rules and safeguards contained in WTO Agreements are amended or omitted.[159] As a result, there is a risk of overlap and even contradiction with the WTO SPS Agreement, thereby limiting the rights and obligations of members under one instrument.[160] The SADC SPS regime, for example, fails to address key notions of the SPS Agreement such as non-discrimination, non-arbitrariness and disguised restrictions on trade whilst the EAC SPS regime does address some of these notions.[161]

There is also a risk of duplication, overlap and contradiction amongst the different RECs which arises because most States are members of more than one REC. Kenya for example, is a member of the EAC and COMESA while Tanzania is a member for both EAC and SADC. The confusion is further compounded by the fact that each of these

153 COMESA SPS Regulations, Regulation 2(b) (iv).
154 Magalhães (2010) 10.
155 WTO SPS Agreement, Article 5(7).
156 Magalhães (2010) 10.
157 Magalhães (2010) 22.
158 Magalhães (2010) 22.
159 Du Plessis (2017) 9.
160 Magalhães (2010) 22.
161 Magalhães (2010) 22.

RECs, in an attempt to mirror the WTO SPS Agreement, may arrive at different obligations.[162] The most evident example is on the provisions on dispute settlement with each RECs having provisions on disputes settlement and as well as the WTO SPS Agreement. Therefore, in the event of a dispute, it may be unclear as to which forum a state is required to approach and whether their rights are limited after seeking relief in one of the forums.

Another issue arises in regard to the aims and objectives of the different Agreements. Each of the RECs has its own SPS regime and each Agreement states aims and objectives of the Agreement. In COMESA, the objectives are provided for under Regulation 2,[163] in EAC under Article 2[164] and in SADC Article 3 provides for the objectives of the SADC SPS Annex.[165] This gives rise to uncertainty particularly when it comes to harmonisation particularly because such clauses have previously yielded widely varying results.[166]

The relationship between voluntary and mandatory measures is ambiguous among the different RECs as they are not discussed in sufficient detail in some of the RECs.[167]

Positive attributes include additions outside the scope of the WTO SPS Agreement – good regulatory practice, active elimination of unjustified SPS measures or regional harmonisation are in order if they clearly have the objective of improving regional integration and boosting intra-African trade.[168]

3. SPS MEASURES UNDER THE TRIPARTITE FREE TRADE AGREEMENT (TFTA)

The first part of this paper has shown that the TFTA has 27 projected member states and by 7th July 2017, a total of 19 countries had signed Tripartite Agreement at the ministerial meeting in Kampala.[169] At the time of writing, the TFTA Agreement in Article 22 provides for sanitary and phytosanitary measures (SPS). The member states agree on this provision to reaffirm their rights and obligations in respect of the WTO SPS Agreement.[170] This is an important commitment by the TFTA members, especially the TFTA members such as Comoros, Ethiopia, Eritrea, Libya, Sudan, and South Sudan who are not WTO members. These countries are to be held to a multilateral standard through a regional scheme. This is accordingly an SPS-Plus commitment at least for such countries. Article 22 proceeds to provide that the member states shall undertake to facilitate safe trade in animals and animal products, plants and plant products whilst safeguarding human, animal and plant life or health.[171] This provision is only a general obligation for the member states but should be attractive to other states not part of the TFTA. This is a direct corollary of having a robust protection system at the TFTA level. Furthermore, Article 22 requires that member states cooperate to eliminate unjustifiable SPS measures to facilitate safe trade in sectors of

[162] Magalhães (2010) 22.
[163] COMESA SPS Regulations, Regulation 2.
[164] East African Community Sanitary and Phytosanitary Measures Protocol (2013) Article 2.
[165] SADC SPS Annex, Article 3.
[166] Du Plessis (2017) 9.
[167] Du Plessis (2017) 10.
[168] Du Plessis (2017) 11.
[169] TRALAC (2017) link 18.
[170] Tripartite Free Trade Agreement, Article 22(1).
[171] Tripartite Free Trade Agreement, Article 22(2).

mutual economic interest.[172] The provision finally, establishes a capacity building programme and indicates that the implementation of the provision would be according to the relevant annex.[173]

3.1 Annex 15 of the African TFTA on SPS measures

At the onset, it is important to mention that the draft annexes of the TFTA have been undergoing negotiation in the past years. This means that the final annex that deals with SPS measures might end up as a different annex once the final instrument is released. This notwithstanding, Annex 15 is referred to in this article as the most current draft. The SPS annex of the TFTA as it stands is an awful case of SPS-Minus provisions of the WTO SPS Agreement and the SPS obligations in the three specific RECs it constitutes; SADC, EAC, and COMESA. The annex has a paltry seven provisions, inadequate, by any standards, of the kind of objectives the TFTA seeks to achieve. It does not incorporate the progressive provisions in SADC, EAC, and COMESA discussed in the previous part either directly or by indirect reference. It is as if the TFTA was being negotiated on a *tabula rasa*. This is undesirable for the objective of progressively eliminating tariffs and nontariff barriers (NTBs) to trade that the TFTA aims at achieving.[174] Additionally, it takes the regionalism advancement in Africa backwards as the desire of having a WTO consistent FTA cannot be achieved. This is because 'duties and other restrictive regulations of commerce (will not be) eliminated on substantially all the trade between the constituent territories in products originating in such territories.'[175]

Some of the states under the TFTA are also members of the WTO. This means that the multilateral obligations stemming from the WTO SPS Agreement will apply to them even without the obligations in the TFTA-SPS Annex. The core substantive provisions of the TFTASPS Annex are largely identical in wording and in purpose to those of the WTO SPS Agreement. There are, however, certain specific provisions that are lacking or not as elaborative in the TFTA-SPS Annex and this may lead to serious legal implications.

The first implication is that the principle of harmonisation is one of the key provisions missing from the TFTA-SPS Annex. The WTO SPS Agreement requires that members 'base their sanitary or phytosanitary measures on international standards, guidelines, and recommendations.' This provision was included as the negotiators of the SPS Agreement aimed to reduce unnecessary trade impacts of national SPS measures by promoting greater convergence of the risk regulatory requirements applied by members. One would think that one of the aims of the TFTA-SPS Annex would be to reduce unnecessary trade impacts of RECs SPS measures, but it seems it was not.

Another implication is that members of WTO, trading in the same product, are required to accept sanitary and phytosanitary measures of other members as equivalent. This is the embodiment of the principle of equivalence. The exporting member needs to objectively demonstrate to the importing member that its measures achieve the importing member's appropriate level of sanitary and phytosanitary protection. The WTO SPS Agreement does not require 'duplication or sameness' of the measures, but 'the alternative' of the

[172] Tripartite Free Trade Agreement, Article 22(3).
[173] Tripartite Free Trade Agreement, Article 22(4); 22(5).
[174] Tripartite Free Trade Agreement, Article 5(a).
[175] GATT 1995, Article XXIV (8) (b).

measure if objectively and scientifically proven should be acceptable. By failing to include this obligation, TFTA member states that are neither WTO members nor COMESA members may find themselves without the obligation of equivalence. Even though it may be argued that this obligation can be traced in the other RECs' obligations, an inclusion in the TFTA-SPS annex would settle the issue once and for all.

A significant omission is that the TFTA-SPS Annex lacks provisions on risk assessment and determination of the appropriate level of SPS protection. Contrastingly, the WTO SPS Agreement requires members to base their SPS measures on relevant scientific evidence as described in Articles 2 and 5 of the WTO SPS Agreement. WTO members are required to base their SPS measures, on an assessment and as appropriate to the circumstance of the risk to human, animal and plant life or health. This was introduced as harmonisation would not be feasible in all cases. Where members' SPS measures cannot be harmonised because no international standard exists, or some members opt for more stringent regulations, the SPS Agreement requires that such national measures have a scientific basis. Thus, science plays an important role in establishing the boundaries of permissible SPS risk regulation. A member introducing SPS measures is required to bring forward scientific evidence which supports the existence of a threat and is specific to the risk of concern. On what basis will the TFTA member states base their measures on and how will they justify the measures? Could this lead to imposition of SPS measures that will only be barriers to trade? Even with the specific SPS on the RECs it is difficult to see how such an important obligation would be absent from the TFTA-SPS annex.

Furthermore, the precautionary principle is only incorporated in the WTO-SPS Agreement. Member states as stated earlier, can depart from the structures of risk assessment. Such a member state must determine that the available relevant scientific evidence or other information is insufficient to complete the assessment. The member state may then adopt a provisional SPS measure on the basis of available relevant information including international standardising organisations and SPS measures of other member states. Applying precautionary measures for a temporary period is considered part of the risk management. Upon additional information being obtained for a more objective risk assessment, members are required to review the measures. The discretion member states have to impose precautionary measures may result into either legitimate trade restrictions or abuse by states. The Author would venture to argue that perhaps this is the reason why it was left out in the TFTA-SPS Annex. It is, however, important to note that the precautionary principle has become so intertwined to most SPS-Plus regional obligations that it is difficult to fathom that it would be excluded from the TFTA-SPS regime.

Finally, the WTO SPS Agreement provides for special and differential treatment in favour of developing countries and least-developed countries. Special and differential treatment as seen before is a principle that seeks to consider the unique needs of developing and least developing countries, granting them favourable treatment in trade so as to increase their capacity to participate in the global trading system. The TFTA-SPS Annex, unlike the WTO SPS Agreement, but similarly to the SADC, EAC, and COMESA SPS regimes has no provisions on special and differential treatment. This could be, as previously argued, due to the fact that the TFTA covers African most if not all are developing or least developed countries.

The annex does not take into account the positive provisions in the three RECs it seeks to amalgamate into one single FTA. If the provisions of the SADC, EAC, and COMESA are anything to go by, the TFTA annex is a far cry from what would have been expected were the provisions in the three RECs to be merged through a process of systemic harmonisation. Specifically, The TFTA in Annex 15 is a case of SPS-Minus because of number of serious shortcomings: lack of important obligations on sufficient risk assessment, non-discrimination, equivalence, the principle of precaution, and specific reference to consultations and dispute settlement. The drafters of the annex did not take into account the progressive provisions set out in the SADC protocol and its Annex VIII, the EAC SPS Protocol, and the COMESA SPS Regulations. With these shortcomings in mind and the problem of multiple and overlapping memberships in the current RECs terrain in Africa still present, it can be easily seen why the author reaches the inevitable conclusion that the TFTA SPS regime is SPS-minus.

4. CONCLUSIONS

NTBs generally and unjustified SPS measures specifically remain a serious threat to the liberalisation of trade in Africa. Most Sub-Saharan African (SSA) countries are dependent on agricultural trade as a focal point of their export earnings so the process of identification, monitoring and elimination of unjustified SPS measures is important in both intra and extra African trade. The difficulties encountered by SSA countries in effective participation in the WTO have had an impact on how developed nations have been able to use SPS measures for protectionist purposes. The best way to address this is greater capacity building among SSA countries with assistance from developed nations.

This article has analysed the SPS measures under three different RECs: SADC, EAC, and COMESA. This was followed by an assessment of the TFTA-SPS measures and found that important obligations on risk assessment, harmonisation, and equivalence have been left out. This omission will have far reaching implications on the liberalization generally, and the elimination of NTBs in intra and extra African trade. These shortcomings, the Tripartite Free Trade Area (TFTA) has the potential for great achievement in the curbing of NTBs generally and unjustified SPS measures specifically if stronger measures on monitoring, transparency, and harmonization obligations are enhanced. The process of regionalism in Africa has made it difficult to deal with unjustified SPS standards as African states are members of different RECs which have intertwining standards creating a ‘spaghetti bowl.’ The augmentation of some of the mechanisms for the identification, monitoring, and elimination of NTBs is highly welcome. The COMESA-EAC-SADC Tripartite mandate is a good example of how this process has begun in Africa. A lot, however, remains to be done to foster free trade in Africa that has the potential of eradicating poverty through wealth and employment creation.

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'Africa for the Chinese'? Revisiting Sino-African Bilateral Investment Treaties

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Abstract: In the 19th Century, Francis Galton made a case for framing British policy on Africa in terms of the replacement of Africa's 'negro' population with the 'China man' because the China man- had every desirable trait. This policy may never have materialised but today, the relationship between Africa and China has taken the form of expanded trade and economic relations with a huge influx of Foreign Direct Investment (FDI) from China to African states. This paper examines this burgeoning economic relationship through the lens of Bilateral Investment Treaties (BITs) entered into between China and African states. This paper examines some of the typical challenges posed by standard BITs and then examines how current China-Africa BITs have addressed those challenges.
Keywords: BITs, FDI, China, Africa, investment, dispute resolution, ICSID, UNCITRAL, sustainability, human rights

1. INTRODUCTION

There was a time when the thoughts of western policymakers skirted around encouraging the displacement of Africa's 'negro' population by the 'good-tempered, frugal, industrious, saving, commercially inclined, and extraordinarily prolific' Chinese.[1] Centuries later, China has rediscovered Africa by herself and bearing these same qualities,[2] China and Chinese investments have made extensive foray into Africa, forming strategic partnerships with the countries on the continent and steadily setting itself up to become the leading player in Foreign Direct Investment (FDI) on the continent.[3] Investment from the West may not necessarily have slowed, but China is increasingly making inroads into the continent, not only providing capital for infrastructural development[4] but also bringing in its corporations, which carry out the infrastructural development or operate in diverse sectors of the economies in States as small and medium scale enterprises (SMEs).[5]

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1 Africa for the Chinese (2017) Link 1.

2 Commenting on the comparative advantage which China has over the west, Suisheng Zhao points out that 'Chinese managers and workers are not only very diligent and disciplined but also normally do not ask for the comfort and expenses that Western expatriates often demand….' see Zhao (2014) 1036.

3 See generally, Vadi (2012) 708 (suggesting that the growing Foreign Direct Investment [FDI] of China 'confirms its economic rise as an active and influential player in international relations').

4 According to the Chinese Ministry of Commerce (MOFCOM), the value of the contracts for infrastructural projects signed by Chinese firms in Africa hit US$65.2 billion in 2016. See MOFCOM, Business Review XXVI (2017) Link 2.

5 According to MOFCOM, the non-financial direct investment flow from Chinese enterprises to Africa increased 25% (by more than US$3 billion). MOFCOM, Business Review XXVI (2017) Link 2.

Perceptions matter and it is interesting to see how China and its engagement with the continent is perceived by Africans. Many African States hold a favourable view of China, according to a 2015 survey of Global Attitudes by Pew Research.[6] This favourable view of China by African States has been considered a consequence of Chinese positive engagement with the continent.[7] In fact, it is largely believed that the motivation for China's burgeoning investment in Africa is without guile and is undergirded by a mutuality of benefits that result from the engagement.[8] Besides, China's diverse engagements within the continent has warmed its way to the heart of African leaders as a strategic partner but also through donations, one of such being the magnificent structure which now serves as the headquarters of the African Union.[9]

It does appear that the above arguments primarily focus, on the economic benefits that inure to the state parties. It is also of immense importance that this blossoming economic relations is examined first in the context of how it measures against prior FDI on the continent and also in the context of Africa's sustainable development and human rights concerns. Framing the Sino-African economic relations in the context of sustainable development and human rights demands a benchmark and the Bilateral Investment Treaty (BIT) offers this benchmark. The choice of the BIT as a benchmark is instructive and it will be shown in the paper that BITs have become the chief instrument by which FDI emanating from capital exporting nations are protected.[10] Presently, there are 35 BITs signed between Africa's 54 countries with China.

The focus on China-Africa BITs is three-fold. Not too long ago, China was more of a recipient of foreign direct investment and during this period, the BITs entered into by China reflected this position and, as pointed out by scholars, these Chinese BITs provide the investors with little protection in practical terms.[11] It also granted China as the host government ample flexibility for its policy direction.[12] , It makes sense to see how much its BITs balance in favour of developmental interests of its counterparty African states especially with the adoption of the Chinese 'going abroad' policy and China's new role as a major exporter of capital to many an African state.

[6] Pew Research Centre (2017) Link 3. See also, 'Views of China and Its Increasing Influence', 2007 Pew Research Centre Survey (2017) Link 4 (showing that a number of Sub-Saharan African countries held highly favourable opinion of Chinese involvement in Africa).

[7] Chen et al (2016) 2 (suggesting that the favourable view of China owes to the 'positive impact of China's engagement on African growth').

[8] Dambisa Moyo, 'Beijing, A Boon for Africa' *New York Times,* June 27, 2012. (arguing that investment by China in Africa is given in exchange for the much-needed resources in Africa. In the authors words: '[t]o satisfy China's population and to prevent a crisis of legitimacy for their rule, leaders in Beijing need to keep economic growth rates high and continue to bring hundreds of millions of people out of poverty. And to do so, China needs arable land, oil and minerals.')

[9] See for instance, Erin Conway-Smith, 'African Union's new Chinese-built headquarters opens in Addis Ababa, Ethiopia' *Global Post* (2012) Link 5 (reporting that 'China's state-run Xinhua news agency said the new AU headquarters 'is not only a new landmark in Addis Ababa but also the latest landmark in the long friendship between China and Africa.'')

[10] See Part II below.

[11] Axel Berger, 'China's New Bilateral Investment Treaty Programme: Substance, Rational and Implications for International Investment Law Making, The Politics of International Economic Law: The Next Four Years' (2008) Link 6.

[12] Ofodile (2014) 156.

Secondly, in addition to Chinese SOEs, the continent has a huge influx of private investments which have found African states as attractive investment destination. Admittedly, this attractiveness of Africa as investment destination may have been motivated by many factors,[13] the least of which may be the existence of BITs between their host nation and China. Until now, there has been no reported case of dispute for which any African state has been held liable. However, these do not preclude the chances that disputes may arise in the future especially as the BITs are characteristically for long term. In addition, as more and more Chinese investors become aware of the rights and protections afforded them by the treaties, there may well be an increased reliance on the treaties in the resolution of investment disputes. In the light of this, it is important that African states are more circumspect in the (re)negotiation of BITs with China in the future to account for provisions that reflect the growing international consensus on the resolution of investment disputes, given the public interests that such disputes characteristically involve.

Thirdly, given the present engagement of China on the African continent and all the rhetoric of mutual benefits, it should be expected that the modus of engagement in Africa should be different from what the continent has known over the years – especially regarding standard BITs which, demonstrated a bias in favour of investment and investors, at the expense of developing states. In more general terms, it will be more interesting to see how much China has deviated from the criticisms that trailed standard North-South BITs.

China-Africa trade scholars do not agree on whether there is a discernible pattern in Chinese-African BITs which suggests that China is exploiting the use of BITs to pursue economic ends on the African continent.[14] Whether this is the case is not the primary purpose of this paper. Instead, the paper examines the state of Chinese-African BITs and sees how much they have departed from the North-South BITs and the concrete terms how they contribute to local economic development but also importantly, sustainable development.

The paper briefly examines the origins of BITs in Section II and how this origin has influenced perceptions which are characterized in this paper as challenges of standard BITs. Section III builds on the criteria characterized as challenges, to see whether Chinese BITs have deviated from these standard BITs which were characteristic of North-South BITs. The China-Tanzania BIT is chosen as basis for comparison, given the sheer size of the BITs. It may not be representative of all the BITs negotiated between China and African states but at the time of publication, this agreement is the most recent. It is largely representative of the progressive trend in China's bilateral engagement with African states and it also represents a snapshot of Chinese attitude on the core issues of sustainable development, in its engagement with Africa. This recent China-Tanzania BIT reflects certain concerns of countries of the Global South and it is argued that sustainable development and human right concerns now necessarily should be a part of the BIT discourse in Africa.

[13] Gu (2009) 571 (the author highlights three reasons that have hitherto motivated the investment of Chinese firms in Africa. First is the starting up of development assistance project, the discovery of niches in the market culminated into investment; others were motivated by the possibility of increased sales and the circumvention of US and EU protective trade restriction policies; finally, some were motivated by the resource prospecting for onward export to China).

[14] See Kidane (2016) 175 ('Although some of the BITs have the hallmarks of the traditional North-South BITs, there is no evidence that China is systematically using BITs to push purposefully a particular economic agenda in Africa'). For a contrary view, Ofodile (2014) 205-6 (the author generally treats BITs in the South-South context with skepticism, especially as most of the 'investment activities implicate the natural resource sector…')

2. BILATERAL INVESTMENT TREATIES AS FDI VEHICLE AND CHALLENGES IN THE AFRICAN CONTEXT

Bilateral Investment Treaties (BITs) have been recognized as the chief instrument by which countries outline the rules that govern the investment of their nationals in individual states.[15] A BIT is a formally concluded and ratified agreement entered into between two states, the essence of which is to guarantee investors from one state – a given level of treatment when they invest in the other state.[16] Their emergence as the choice means of investment protection began to gain prominence following two interrelated events that dominated foreign investment in the 1960s and 1970s[17] Firstly, capital exporting nations began to experience aggressive and continued attacks on the interests of their nationals abroad, marked by the expropriation of their interests.[18] These aggressive and sustained attacks had begun to whittle down the influence of the Hull Rule which was hitherto a rule of customary international law which provided foreign investors from expropriation.[19] These aggressive attacks resulted in great uncertainties regarding the settlement of the growing cases of expropriation.

Secondly, the growing cases of expropriation was further exacerbated by the process of decolonization which saw western nations 'letting go' of their colonies and as they began to relinquish political authority over their colonies, it was necessary to protect both their investments and investors, who have interests within the colonies.[20], The Hull Rule had begun to lose its influence as former colonies began to emerge as new autonomous and independent states. The convergence of states around the Hull Rule was predicated on the role played by colonial masters in driving the state policy of their colonies. These colonies, as sovereign states, as well as other developing countries soon asserted themselves,[21] claiming not only the 'right to determine how they would treat investors', but also, 'the

15 Salacuse and Sullivan (2006) 67.

16 See Sheffer (2011) 484.

17 Some scholars have linked the origin of BITs to the evolution of the investment protection function of formal treaties known as the Treaties of Friendship, Commerce and Navigation, which came into exist Post World War 2. See for e.g. Sheffer (2011) 485.

18 These attacks came in the form of nationalization programs embarked upon by many 'underdeveloped' nations. See for instance, Dias (1970) 59 (analyzing the methods, motives and benefits of the nationalization of foreign owned interests undertaken by the Tanzanian government).

19 Early in the 20th Century, principal nations of the world held the opinion that the investment of an alien was entitled to the protection of international law, so that an expropriation by the nation hosting the investment must be compensated promptly, adequately and effectively. This sums up the Hull Rule which derived its name from diplomatic exchanges between the then US Secretary of States Cordell Hull and the Mexican Minister of Foreign Affairs, in respect of the seizure of properties of foreigners by the Mexican government between 1915 and 1940. See generally, Guzman (1998) 644–45.

20 Guzman (1998) 644–45.

21 Developing states took advantage of their dominance of the United Nations General Assembly to pass several resolutions which helped to seriously undermined the value of the Hull Rule as a rule of customary international law. Some of the resolutions include: resolution 1803 (XVII) on the 'Permanent Sovereignty Over Natural Resources'; resolution 3171 (XXVIII) also on the 'Permanent Sovereignty over Natural Resources'; resolution 3201 (S-VI) on 'Declaration on the Establishment of a New International Economic Order'; and resolution 3281 (XXIX) being the 'Charter of Economic Rights and Duties of States'.

standard of compensation that should apply if that treatment is sufficiently harmful.'[22] Investment protection measures became imperative when decolonization, coupled with the wave of nationalization hit feverish pitch. BITs, as a way around the lack of an internationally recognized rule for investor protection,[23] increasingly began to fill this void.[24] In essence, the BITs serve the purpose of providing stability to the investment environment of the host states as well as providing for an alternative to the existing legal regimes in the host countries which may not adequately protect FDI.[25]

It has however been considered a paradox, that countries of the developing world which so stoutly opposed the now defunct Hull Rule, as a norm of international law, willingly warmed up to the embrace of BITs, which offered to foreign investors, more protection than the Hull Rule.[26] The expectation on the part of many developing countries was, and still is, to give 'credibility to commitments made to investors.'[27] Knowing that it does require some level of confidence on the part of foreign investors to invest in another country, the BITs serve as binding tokens of commitment to protect the investments, and thereby attract FDI.[28] However, the foregoing discussion suggests that the circumstances of its original use focused on the protection of the interests of developed states in developing ones that play hosts to investments of the former in the latter.[29]

In the light of their origins, certain criticisms have been levelled against traditional BITs which turn on their general outlook and provisions. These criticisms, are characterized as challenges of standard BITs and are examined below.

A. Power Relations in Negotiation and Ratification of BITs

BITs were, usually by their nature, between a country of the developed world and one from the developing world and presupposed a contractual relationship between a strong and weak party.[30] This power relation has been said to have consequences especially for the

[22] Guzman (1998) 641.

[23] See for instance the opinion of the International Court of Justice in *Barcelona Traction, Light and Power Company, Limited (Belgium. v. Spain) 1970 I.C.J. 3, 46–47 (Feb.5),* lamenting the absence of an internationally accepted rule on foreign investment. The august court opined:
Considering the important developments of the last half-century, the growth of foreign investments and the expansion of the international activities of corporations False and considering the way in which the economic interests of states have proliferated, it may at first sight appear surprising that the evolution of law has not gone further and that no generally accepted rules in the matter have crystallized on the international plane.

[24] Salacuse and Sullivan (2006) 70 ('For all practical purposes, BIT law has become the fundamental source of international law in the area of foreign investment.').

[25] Johnson (2010) 925 ('Thus, BITs reduce the expected risks to FDI in two ways: first, they stabilize a host country's existing investment environment; 38 and second, they provide substitutes for weak domestic laws and institutions that are often ill-equipped to protect FDI.').

[26] Guzman (1988) 642.

[27] Wells (2005) 444.

[28] Tobin and Busch, (2010) 4 (the authors reasoned that 'the hope for BITs is that, if they boost investor confidence, they are likely to result in greater inflows of FDI.').

[29] See Ofodile (2014) 138 ('BITs were specially designed by Western nations in the wake of decolonization in the 1950s and 1960s to protect their investors and the investment of their investors in developing countries.').

[30] For instance, the United States has entered into roughly about 42 BITs. None of the listed parties to the BITs may be categorized as developed country. For a list of US BITs, see Link 7.

developing nations. Firstly, the developing nations negotiated and entered into the BITs without the requisite experience to fully understand the dangers the agreements posed to their national interests and how it is very much skewed to benefit the foreign investors.[31] This realization has led some countries of the developing world to commence the review of their BITs. One such example is South Africa. In a position paper at the end of the noughties, their Department of Trade and Industry pointed out the issues arising from the inexperience that accompanied the signing of majority of the BITs and how it has resulted in divergence between protection afforded under South African law and under the BITs. To this extent, the Department proposed closer scrutiny and review of the BITs.[32] In fact, pursuant to this scrutiny and review, the government of South Africa as at 2013, had followed through with the termination of several expiring BITs, in order to protect and strengthen its investment regime, and also preserve its sovereign right to pursue policy objectives.[33] This policy objectives shall be returned to in the paper.

The need to protect foreign investments from unconscionable and arbitrary interference by the governments of host countries cannot be discounted, especially in the light of the nationalizations of the 1970s. There was however a problem. The weaker position occupied by these developing countries may have led them to pursue FDI by competing with other developing countries. This engendered regulatory competition that meant loosening their investment regulation regime.[34] Loosening investment regulation regime implied the acceptance of constraints with regard to the powers of these developing countries to undertake public interest objectives and creating a leeway for the possible abuses of human rights.[35]

Finally, although the language of the BITs presuppose that the parties enjoy reciprocal rights, this in reality is hardly ever of any serious consequence for the host states, given the unidirectional flow of investment i.e. from the developed to the developing economy. Developing countries hardly ever benefit from the elaborate provisions of rights and the ideal would therefore be to balance these rights against obligations on the part of the investors. However, these BITs hardly ever provided for investors’ obligations. This accounts for the much talked about imbalance engendered by the BITs.[36]

B. Lack of Flexibility to Support State Policy Objectives

BITs generally involve wide ranging commitments on the part of the host state.[37] These commitments are couched as rights of the investors and investments of the host states. A cursory look at these commitments may reveal no harm. However, their effect becomes

[31] Sheffer (2011) 492.

[32] South Africa Department of Trade and Industry (2009) Link 8.

[33] Leandi Kolver (2013) Link 9. Some other developing countries outside of Africa have also either taken steps to terminate BITs entered with several countries or have already done so. See for instance, Ben Bland and Shawn Donnan (2014) Link 10.

[34] Chalamish (2009) 317 (suggesting that the surge of FDI to jurisdictions with low standards may force the loosening of regulatory standards, creating a so-called race to the bottom).

[35] Human Rights Council (2017) Link 11 ‘capital importers that lacked significant market power felt increasingly pressured to compete with one another for investments by accepting ever-more expansive provisions, constraining their policy discretion to pursue legitimate public interest objectives.’

[36] See Jeswald and Salacuse (2010) 464.

[37] Kaushal (2009) 498.

more glaring in the context of Less Developed Countries (LDCs) or developing countries as they seek to forge policies aimed at sustainable development and promoting domestic development strategies. The standard of treatment clause helps to appreciate the policy constraints which LDCs and their developing counterparts face. Typically, standard BITs require that the host-state afford the investors and investments of the counterparty national treatment. This means that the same treatment that the host state provides its nationals should be afforded investors from the counterparty state. For many African countries still grappling with developing their local industries and their small and medium scale enterprises (SMEs), some level of discrimination is not only desirable but imperative, in order to give locals a chance to compete or to help a particularly disadvantaged section of society.[38] Commenting on the invasive nature of traditional BITs, the South African Department of Trade and Policy pointed out that:

> BITs extend far into developing countries' policy space, imposing damaging binding investment rules with far-reaching consequences for sustainable development. New investment rules in BITs prevent developing country governments from requiring foreign companies to transfer technology, train local workers, or source inputs locally. Under such conditions, investment fails to encourage or enhance sustainable development.[39]

A breach of such provisions on national treatment may render government policies in this direction liable to attack by foreign investors. This realization has led developing countries to rethink the national treatment provision. Typical south-south BITs either do away with the concept of national treatment for FDI[40] or provide exceptions which for instance, accommodate steps by host countries to empower their local industries.[41]

C. Issues in Dispute Resolution Between the State and Investor

Many BITs provide for the settlement of investor-state disputes through the use of arbitration. When BITs provide for investor-state arbitration, it affords private investors from the state parties to the BIT to seek remedy for injuries they purportedly suffer, arising from the acts of the host state that are in breach of the substantive provisions of the BIT.[42] The acts of the hoststate which ground the remedy sought may be of general application or may be specifically designed to promote a public policy goal of the host state. The foregoing has led to challenges to the way disputes between the host state and investors are resolved. Some of these problems are highlighted below.

[38] Salgado (2006) 1040 'As drafted, the national treatment provision does not recognize a state's right to grant preferential treatment or reward its citizenry as a means of furthering legitimate policy objectives, such as environmental protection, employment stability, and infant industry development, just to name a few.'

[39] See South African Department of Trade and Industry (2017) Link 8.

[40] See for instance, the Egypt-Zambia BIT (2017) Link 12.

[41] See for instance, Article 2(4) Nigeria-Egypt BIT (2000) Link 13. (It provides that: 'Notwithstanding the provisions of paragraphs (2) and (3) of this Article, either Contracting Party may grant within the framework of its development policy to its own nationals and companies special incentives in order to stimulate the creation of local industries, provided that they do not significantly affect the investment and activities of nationals and companies of the other Contracting Party.')

[42] VanDuzer (2007) 684.

1. Arbitration as Means of Dispute Resolution

BITs typically relied on international arbitration as a means of settling disputes which arose from investment. As a result, local courts were bypassed and international arbitration tribunals were vested with jurisdiction over the disputes. The worry for developing states stemmed from the tendency of large multinationals to pursue the settlement of disputes through the international arbitration tribunals provided for in the BITs, to the detriment of economy of the host states and the capacity of the host states to provide public goods for their citizens. A vast number of investor-state dispute claims are initiated annually.[43] The costs and awards against host-states, as well as the use of the dispute settlement mechanism provided for in the BITs to challenge the provision of public goods by host states have been particularly troubling for developing countries. As a result, states are beginning to reconsider the inclusion of investor-state disputes resolution in the form of international arbitration in the negotiation of BITs.[44]

2. Lack of Transparency and Openness to Third Party Participation in Dispute Resolution

In the light of the public interest dimension of investor-state disputes, the case has been made for an increased public access to the dispute resolution process,[45] as it will 'ensure public acceptance of the result and the democratic accountability of the process.'[46] The lack of transparency or participation by third parties to the BITs stems from the nature of international commercial arbitration, on which investment-state arbitrations are originally modelled. A key advantage touted in favour of international commercial arbitration is confidentiality. This confidentiality does not generally sit well with the interests of state parties, who beyond the commerciality of the transaction still have to cater to a broad range of public policy issues as well as the judicious allocation of tax payers' monies. [47]

The International Centre for The Settlement of Investment Dispute (ICSID) and the United Nations Commission on Trade Law (UNCITRAL) have taken steps towards ensuring transparency. In the case of ICSID for instance, information which includes the names of the parties, the subject matter of the dispute, and the names of the arbitrators are now accessible to the public. However, more substantial information such as the argument

[43] Between 2011 to 2016, an average of 61 cases were initiated through the International Centre for The Settlement of Investment Dispute (ICSID). ICSID (2017) Link 14.

[44] For instance, in 2016, the South African President signed into law, the Promotion and Protection of Investment Act, 2015 (2017) Link 15. The Act in sum prescribes the use of mediation, and then the use of the domestic legal process in investment dispute resolution. Although the state may accede to arbitration, this follows after the exhaustion of domestic remedies and is between states. The Act is publicly available.

[45] One author has rhetorically questioned whether 'the far-reaching penetration of foreign investment guarantees into areas of national regulation of public interests should not be counterbalanced by corresponding opportunities for access to justice and the availability of remedies for civil society in the host State of foreign investments.' Francioni (2009) 729–47 (abstract).

[46] VanDuzer (2007) at 685.

[47] See for instance, Seznec (2004) 211 ('The extent to which transactions are not to be treated as ordinary commercial transactions but as important matters of public policy and national sovereignty cripples the international dispute resolution system as a whole because the underlying interests of the parties are so fundamentally different.')

of the parties, the minutes and records of proceedings are not accessible.[48] The parties may agree to the confidentiality of the final award of the tribunal, in addition to the inaccessibility of the arbitration proceedings to the public, unless the parties before the tribunal agree otherwise.[49]

The UNCITRAL Rules and Convention on Transparency[50] have now gone a step further to do more towards providing for access and transparency in the process of investor-state arbitration.[51] The challenge however posed by the Rules is that it does not apply to the investment treaties which came into effect prior to 1 April 2014, the effective date of the Rules, unless the parties to the investment treaty agree to its applicability. The challenge is made significant with the realization that there already exist over 3000 investment treaties which will require the parties to agree on the applicability of the Rules to disputes arising from the treaties. Although the Mauritius Convention on Transparency has been adopted, providing the possibility for the application of the UNCITRAL Transparency Rule to arbitration commenced under the UNCITRAL Arbitration Rules or other rules of arbitration, there is still the possibility for parties to the Convention, to make reservations or exclude treaties from the purview of the Convention.[52] To avoid undercutting the transparency drive, it has been argued that the default rule of investment arbitration be changed from confidentiality to transparency.[53] A futuristic argument can be made to the effect that states contemplating signing BITs may expressly provide for transparency in the arbitration clause of their dispute settlement provision. This takes care of any transparency worries *ab initio*.

3. CHINESE BILATERAL INVESTMENT TREATIES – ANOTHER SLIPPERY SLOPE FOR AFRICA?

Understanding the current trend of Chinese investment in Africa is important. Colonialism and the attendant exploitation of the natural resources of countries in Africa, amongst other factors, have been blamed for the weak institutions in many states in Africa as well as the persistent underdevelopment of the continent.[54] Chinese investment in Africa is often in the nature of natural resource extraction and has informed the cautionary tale of some form of neo-colonialism and its capacity to continue to further underdevelopment on the

48 Sheffer (2011) 494–95.

49 Sheffer (2011) 494–95 (author argues further that ICSID stakeholders have opposed steps towards greater transparency in ICSID).

50 The Rules were adopted on 16 December 2013 and came into effect on 1 April 2014. See generally UNCITRAL Transparency Rules (2017) Link 16.

51 These measures include the public availability of parties to the dispute, the economic sector involved, and the treaty on which the claim is based; public access to hearings and; third party and non-disputing party submissions to the tribunal.

52 See generally, Article 3 of the UN Convention on Transparency in Treaty-based Investor-State Arbitration (2107) 17.

53 See Billiet (2016) 46.

54 See for instance Nunn (2007) 157–75 (developed a model to explain why colonial rule contributed to underdevelopment in Africa and even though it has ended, it continues to matter in Africa's underdevelopment).

Acemoglu et al, (2001) 1369–1401 (showing that in previous colonies where the policy of the colonial masters was focused on resource extraction, weak private property institutions were established and such institutions continued even after independence).

continent.[55] Furthermore, like the case with most of the developed nations of the global North, investment, in most cases, is, unidirectional, so that the benefits that the protections afforded by BITs still favour the capital exporting country. Against this background, the Chinese BIT with Tanzania is examined, to see if, and how it has deviated from the standard BIT.

The China-Tanzania BIT is not a template of all other existing BITs between African states and China but, being the latest BIT with an African state, it may well represent the evolved approach of China in its BIT engagement with African states.

A. Flexibility in Standards of Treatment

If African 'owned' businesses will ever have a chance of survival or growth, it is imperative that the BITs negotiated between African states and China allows for flexibility around certain core provisions that feature prominently in the BITs. It cannot be denied that the business terrain in many an African state could be incredibly difficult given the lack of both physical and legal infrastructure. The Chinese have shown grit in weathering the terrain.[56] Consequently, a national treatment provision for instance, may prove to be detrimental to the interest of local businesses. This provision like in many BITs between China and African states feature in the China-Tanzania BIT. The China-Tanzania BIT does however accommodate flexibility in respect of its national treatment provision by subjecting national treatment to the national laws and regulations of the host-state, relating to the 'operation, management, maintenance, use, enjoyment, sale or disposition of the investment' within the host-state.[57]

With the above provision, it may be difficult to fit into these criteria, policy objectives of the host state that seeks to bolster local industries, and provide a chance against the very competitive Chinese businesses. Hence, the BIT provides that pursuant to national laws and regulations, the contracting parties are at liberty to

> … grant incentives or preferences to its nationals for the purpose of developing and stimulating local entrepreneurship provided that such measures shall not significantly affect the investments and activities of the investors of the other Contracting Party.[58]

This provision very much mirrors south-south BIT provision on national treatment. This provision ensures the flexibility of the host-state in driving policy relating to local

[55] Reuters (2011) Link 18; see also Lamido Sanusi (2013) Link 19 (the author, a former Governor of Nigeria's Central Bank opined as follows: '[s]o China takes our primary goods and sells us manufactured ones. This was also the essence of colonialism. The British went to Africa and India to secure raw materials and markets. Africa is now willingly opening itself up to a new form of imperialism.')

[56] See Gu (2009) 578 ('When asked about their perception of the investment climate in Africa in general, there is even a saying among the Chinese investors that "Despite the strong wind and wild waves, the deepwater still has fish to be found.")

[57] Article 3(1) of the China-Tanzania BIT provides that '[w]ithout prejudice to its applicable laws and regulations, with respect to the operation, management, maintenance, use, enjoyment, sale or disposition of the investments in its territory, each Contracting Party shall accord to investors of the other Contracting Party and their associated investments treatment no less favourable than that accorded to its own investors and associated investments in like circumstances.'

[58] Article 3(2) China-Tanzania BIT.

businesses and also balances protection for investors and investment of capital exporting state. While a significant impairment of the investors and investment of the capital exporting state is not expressly defined, it may well be determined on a case by case basis depending on the industry; the effect on returns on capital invested; and whether the investor has been apprised of the policy of the host-state to incentivize or prefer its local industries at the point of admitting the investment.

B. Dispute Resolution in the China-Tanzania BIT

Interestingly, China as a host-state for FDI notably did not elaborately provide for investorstate dispute resolution, or where such provisions existed, they were very much limited.[59] More directly, in order to protect China as a host state, the BITs had provisions which allowed China the right to agree on the resolution of disputes on the basis of each individual case. The China-Tanzania BIT does reflect this form of protection too. The BIT first advocates recourse to alternative dispute resolution (ADR) methods for the resolution of investor-state disputes. When the ADR procedure cannot resolve the conflict between the parties, the investor may then initiate formal dispute settlement procedures 6 months from the initiation of ADR.[60] Given this provision under the BIT, it is clear that ADR must necessarily precede the commencement of formal settlement of investor-state dispute. This may be regarded as an improvement for those Global South countries who are particularly concerned about the immediate recourse to arbitration. This period may help the investor and state reach an amicable resolution of the dispute.

After the 6-month period, the investor may pursue domestic litigation, arbitration submitted to ICSID under the Convention on the Settlement of Disputes between States and Nationals of Other States; or under the arbitration rules of UNCITRAL; or to any other institutional or ad hoc tribunal agreed upon by the disputing parties.

There is no mention of transparency and accessibility of the arbitration procedure by interested third parties in the BIT. Although ICSID and UNCITRAL Rules (recognized in the BIT) have taken steps to ensure transparency and accessibility, the inherent limitations of these steps still pose some already identified challenges. It will therefore be important that clear and unambiguous provision is made for transparency and access, especially by relevant interest groups where investor-state disputes are to be resolved by arbitration. In the African context where it is not altogether impossible for collusion between government officials and (not necessarily foreign) investors, transparency and public access through the participation of non-governmental organizations and advocacy groups can play a critical role, by offering perspectives to investment disputes that may possibly arise, which neither the state nor the investors may avert their minds.[61]

C. Promotion of Sustainable Development in Host States

It has been already mentioned that part of the drive for Chinese investment in Africa is due to the natural resources required by China's resource-intensive growth model.[62] In addition, China is engaged in a flurry of infrastructural development projects and Chinese companies are setting up businesses in different parts of the continent. This has come with continuing

59 Article 3(2) China-Tanzania BIT.
60 Article 13(1) and (2) China-Tanzania BIT.
61 VanDuzer (2007) 685.
62 Dollar (2016) xiii.

environmental[63] and social costs.[64] A concrete approach to ensuring sustainable development is still lacking despite the China-Tanzania BIT meeting several of the concerns expressed by countries of the Global South in respect of standard BITs.

The China-Tanzania BIT sets out the objectives of promoting ‘healthy, stable and sustainable economic development and to improve the standard of living of nationals’[65] but there are no substantive provisions in the treaty which are directed towards the attainment of these objectives.[66] The closest the BIT comes to addressing possible sustainability concerns is in respect of reasonable measures taken by the host state in the interest of sustainable development concerns.[67] This is not very helpful as it only deals with cases where expropriation is in issue, without the imposition of any direct and active duty on the investor to incorporate sustainability in its investment.

China and many other Asian countries once had the reputation of providing manufacturers with cheap labor. However, the rising Chinese labor costs may mean that Africa is the next manufacturing frontier,[68] given its favourable tariffs and the accessibility to the EU and US markets.[69] It becomes very important that the BITs protect as much as possible, labor rights, environmental rights and many other considerations which will ensure that African economies do not isolate sustainability in their growth trajectory. Now, given that host states in Africa may not necessarily have an adequate protection or enforcement regime, obligating Chinese investors to undertake social and environmental assessment before undertaking projects may be a starting point.

4. CONCLUSIONS

This paper has examined the bourgeoning interest of China on the African continent. This relationship as the paper points out has seen huge capital and infrastructural investment on the continent, both by Chinese SOEs as well as private investors in the form of SMEs. The paper narrowed down its examination of the growing relationship to the BITs between African states and China. The aim was to see how these BITs may have evolved, in the light of several misgivings expressed by countries of the Global South against standard BITs, often negotiated between these countries and developed ones. Using the China-Tanzania BIT as the measuring stick, this paper admits that some of the misgivings have been dealt

[63] See for instance, Tife Owolabi (2016) Link 20.

[64] See for instance, Amnesty International (2017) Link 21.

[65] See preamble to China-Tanzania BIT.

[66] Kidane (2016) 164.

[67] Article 6(3) of the China-Tanzania BIT provides that:

Except in rare circumstances, such as where the measures adopted substantially exceed the measures necessary for maintaining reasonable public welfare, legitimate regulatory measures adopted by one Contracting Party for the purpose of protecting public health, safety and the environment, and that are for the public welfare and are non-discriminatory, do not constitute indirect expropriation.

[68] See for instance, WitsJournalism (2017) Link 22.

[69] See for instance the US African Growth and Opportunity Act (AGOA) (Title I, Trade and Development Act of 2000; P.L. 106–200). The Act removes barriers and other obstacles to trade between the sub-Saharan Africa and the US and generally enhances trade preferences in favour of the former. The AGOA (2000) Link 23. There is also the Economic Partnership Agreements (EPAs) negotiated between the EU and the countries of Africa, the Caribbean and the Pacific. The aim of the EPAs the is to promote trade and thereby engender sustainable development and the alleviation of poverty.

with and it has made a case for strengthening sustainable development considerations in the BITs. Previous engagement with developed countries and the social and environmental impacts of such engagements serve as a cautionary tale for Chinese investment in Africa, especially given the sectors where they operate. Accommodating sustainable development in future BITs, it is believed, will provide some balance, so that whilst protecting investors, host African states attain meaningful development.

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The South American Way: Sub-regional Integration under ALBA and UNASUR and International Dispute Resolution

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Have you ever danced in the tropics?
With that hazy lazy
Like, kind of crazy
Like South American Way

(Carmen Miranda & Bando Da Lua, 1959)

Abstract: This article describes two of the most recent sub-regional integration efforts in South America, namely ALBA and UNASUR, including the factors that have contributed to their development. The analysis offered here pays special attention to the role played by the Venezuelan government, particularly during the administration of former president Hugo Chavez, both in political and economic terms toward the rise and growth of ALBA. This article also explains how the heavy dependence on Venezuela's support was also detrimental to ALBA for it has been negatively affected by the crisis currently faced by the Latin American country. In contrast to the case of ALBA, this article discusses the rise of UNASUR as a collective endeavor and the efforts of its members to create a regional framework that includes a novel proposal of a Centre for the Settlement of Investment Disputes.
Keywords: Latin America, Sub-regional integration, UNASUR, International dispute resolution, ALBA

1. INTRODUCTION

This article describes two of the most recent sub-regional integration efforts in South America, namely ALBA and UNASUR, including the factors that have contributed to their development. The analysis offered here pays special attention to the role played by the Venezuelan government, particularly during the administration of former president Hugo Chavez, both in political and economic terms toward the rise and growth of ALBA. This article also explains how the heavy dependence on Venezuela's support was also detrimental to ALBA for it has been negatively affected by the crisis currently faced by the Latin American country. In contrast to the case of ALBA, this article discusses the rise of UNASUR as a collective endeavor and the efforts of its members to create a regional framework that includes a novel proposal of a Centre for the Settlement of Investment Disputes.

Section II of this article describes context and the conditions that led to the rise and growth of ALBA and UNASUR as part of the most recent wave toward regional integration

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in Latin America and the Caribbean. This section also discusses the critical role of Hugo Chavez in marshaling the promotion of regional integration in Latin America as a way to expand his political base and build strategic alliances throughout the region and beyond. This article also offers a comparison between ALBA and UNASUR regarding their scope, structure and other features, therefore highlighting some important differences and similarities among them.

Section III turns its attention to the proposal made within the framework of UNASUR to create a Centre for the Settlement of Investment Disputes as a better alternative to ICSID. This section delves into some of the main features of this proposed dispute processing mechanism and briefly mentions some of its challenges. Section IV contains a brief conclusion.

2. LATIN AMERICAN INTEGRATION 2.0

Regional and sub-regional integration have been an aspiration of Latin American countries for many decades.[1] One would imagine that such goals are easy to attain given the geographical proximity, comparable challenges and common historical ties that bind the countries of the region. Nevertheless, the road to integration has been rocky to say the least. Latin American countries have attempted to organize and build strong alliances that help them tackle their common obstacles and strengthen their presence in the regional and global markets as the European Union emerged, grew stronger and became a powerful global competitor.[2]

With a few exceptions, Latin American arrangements have tended to involve only a sub-group of countries and have also mainly focused on trade relations and economic integration e.g. MERCOSUR, CAN, CARICOM, CARIFTA, DR-CAFTA. Notwithstanding, some of the most recent efforts, in part due to the leadership of countries like Venezuela, have also focused on political integration. The two most notable examples of these latter efforts are the Bolivarian Alliance for the Peoples of Our Americas (ALBA, for its initials in Spanish: *Alianza Bolivariana para los pueblos de nuestra América*),[3] and the Union of South American Nations (UNASUR, for its initials in Spanish: *Unión de Naciones Suramericanas*).[4]

Both ALBA and UNASUR stemmed or gained force from initiatives championed by Hugo Chavez, the self-proclaimed father of the Bolivarian Revolution and president of Venezuela between 1999 and 2013. Chavez named his political movement after Simon Bolivar, the 19th century Venezuelan hero who led the independence of several South American nations from Spain and first proposed the idea of a united continent that would stand strong against the colonial European superpowers.[5] The 170 years that passed between Bolivar's death in 1830 and the election of Chavez as president of Venezuela in 1999, witnessed many ups and downs throughout Latin America.

The former Spanish and Portuguese colonies (Brazil), upon gaining independence, were able to attain their own national identities and cultures, build their own legal systems, government institutions and other structures typical of any modern society. On the other

[1] Baumann (2008) link 1.
[2] Indart, Lengyel (1995) link 2.
[3] See, Portalalba (2017) link 3.
[4] See, UNASURSG (2017) link 4.
[5] Gómez (2012).

hand, they also endured intermittent periods of civil war, political instability, and economic crises. Contingent upon their relative wealth, which often derived from the exploitation of natural resources, their institutional and political stability, and other factors; some Latin American and Caribbean countries did better than their neighbors during certain periods of time, but the region as a whole always fell short of attaining an ideal level of progress and integration.

The rise of Chavez as a regional leader of sorts and the widespread of his political movement was not only a product of his charismatic personality or populist tactics, but also the result of Venezuela's sudden wealth caused by a meteoric increase in the price of oil that started in the year 2000. Such perfect combination allowed a relative outsider to politics like Chavez to purchase votes, harvest political allies and to also ruffle many anti-American, anti-capitalist feathers across the region and beyond. Chavez's political movement vowed to eradicate poverty and inequality, promote economic progress and development, and fight the expansion of capitalism by promoting a new version of socialism dubbed 'Twenty-first century socialism' *(Socialismo del Siglo Veintiuno).*

Some of the most visible allies were Fidel Castro from Cuba, Evo Morales from Bolivia, Lula Da Silva and Dilma Roussef from Brazil, Rafael Correa from Ecuador, Daniel Ortega from Nicaragua and Cristina Kirchner from Argentina. Other important leaders from Latin America and beyond were also openly sympathetic to the movement and to Chavez's unapologetic demeanor and provocative rhetoric especially against the United States, which contributed to cement his image as a world leader for the disenfranchised.

The dawn and dusk of ALBA?

ALBA (which also means 'dawn' in Spanish) emerged from a bilateral agreement signed between Cuba and Venezuela in 2000 whereby Cuba sent doctors, teachers and sport trainers to Venezuela in exchange for a quota of Venezuela's oil production.[6] The agreement was marshaled as an effort to promote social welfare through bartering and other forms of economic aid between Latin American and Caribbean nations, and was initially promoted as an 'alternative' to the Free Trade Area of the Americas (FTAA) championed by the United States in the early 2000s.

ALBA was, in fact, an alternative to the free market proposal of the United States and its allies, but its founders decided to drop that reference and instead called it an 'alliance'. The Cuba-Venezuela model was broadened to eventually include nine more countries, with Venezuela usually playing the role of patron or financial backer, and Cuba providing the manpower and technical assistance.

It is important to highlight the role of Cuba, which since the early 1960s had been sending thousands of health workers to Africa, Asia and Latin America publicized as humanitarian efforts but with evident political undertones. Critics, who often termed these strategies 'doctor diplomacy',[7] called them out as an attempt by Fidel Castro to spread the socialist ideology while eliciting sympathy for the Cuban revolution. Chavez launched a renewed version of these programs in Venezuela in the early 2000s, through a series of

[6] See Convenio Integral de Cooperación entre la República de Cuba y la República Bolivariana de Venezuela [Integral Cooperation Accord] (2017) link 5.

[7] Beato-Nuñez, et al. (2000) link 6.

programs called 'Missions' *(Misiones),* which became the centerpiece of that country's social policies and Chavez's main vote purchasing strategy and clientelistic political platform.[8]

ALBA was much more than a political agreement. Its trade component entailed the launching of a virtual regional currency,the SUCRE, that would be used for commercial exchanges among those participating in ALBA's trading bloc instead of the U.S. dollar.[9] The SUCRE was poised to become a hard currency similarly to the European Union's Euro, but its implementation has met some obstacles that are beyond the scope of this article.[10]

Taking advantage of record high oil prices that lasted until the beginning of the present decade, Chavez directed billions of US dollars toward the promotion of social welfare programs around Latin America and the Caribbean. This strategy allowed Chavez to also spread his political ideology and build strong alliances in the region and beyond.[11] ALBA also gave Cuba a much-needed lifeline to stay afloat and brought renewed visibility to the purported accomplishments of the Castro revolution regarding social programs and accessible healthcare.

As oil prices plummeted and Chavez succumbed to a terminal disease, ALBA lost Venezuela's financial backing and the political support of its main promoter. Preoccupied with the deep economic and political crisis that resulted in part from the sharp decline in revenues that hit Venezuela, President Nicolas Maduro, Chavez's designated successor, has been unable to maintain the position of influence that his country once had in the region, let alone garner political support for himself.

At the time of writing, the once incredibly wealthy Venezuela is immersed into the deepest economic crisis of its history. With more than 80% of the population living under the poverty line, widespread scarcity of foodstuff and medicines, one of the highest murder rates in the region, and an openly authoritarian regime –the South American country has gone from riches to rags in less than a decade and the regional efforts it supported have obviously suffered as a consequence.

The absence of Venezuela at the helm of ALBA and the recent shift in the regional political landscape has been a debilitating factor for the sub-regional agreement, at least in the short term. Only time will tell if these developments signify the dusk of this regional initiative, or if on the contrary, they only represent a hiccup in an otherwise successful journey toward the realization of Simon Bolivar's dream.

The rise and transformation of UNASUR

The rise of UNASUR, unlike the case of ALBA cannot be credited solely to Chavez's influence. South American nations had already worked toward establishing important sub-regional trading blocs like CARICOM, SICA, CAN and MERCOSUR, but these have fallen short of the idea of a full and efficient integration. Table 1 shows the most important regional agreements in the region during the 20th century.

[8] Gomez (2012).
[9] See Sucrealba (2017) link 7.
[10] Rosales et al. (2011) link 8.
[11] Corales and Penfold-Becerra (2011).

Table 1. Regional and sub-regional agreements in Latin American and the Caribbean

Agreement	Date
Central American Common Market (CACM)	1960
Latin America Free Trade Association (LAFTA)	1961
Caribbean Free Trade Area (CARIFTA)	1969
Andean Common Market (ACM)	1969
CARICOM	1973
Latin American Integration Association (LAIA)	1980
MERCOSUR	1991
ALBA	2004
UNASUR	2008

Chavez's political clout and economic power was certainly important for the creation of UNASUR in 2008, but the structure of this sub-regional agreement appears to be less dependent on Venezuela than ALBA. Even after the death of Chavez and the change of fate that continues to affect the once wealthy and influential South American nation, UNASUR members seem to be determined toward reaching their goal.

Very much like in the case of the European Union, economic integration has been only part of UNASUR's plan. Its goals extend to policies and action plans regarding political agreements, community identity, energy cooperation, environment, democracy, food, health and education.[12] The group of twelve member nations (Table 2), some of which are also part of CAN, MERCOSUR, the Alliance of the Pacific (AP), and CARICOM agreed to create an ambitious supranational structure comprising four bodies,[13] twelve ministerial councils, a parliament, a regional bank, and an Institute of Government in Health. The group has also admitted two observers, Mexico and Panama, and its current rotating pro tempore president is Argentina's Mauricio Macri.

Table 2. UNASUR membership

Country	Regional and sub-regional membership
Argentina	Andean Community (CAN)-Associate MERCOSUR
Bolivia	Andean Community (CAN) MERCOSUR-Associated
Brazil	Andean Community (CAN)-Associate MERCOSUR
Chile	Andean Community (CAN)-Associate MERCOSUR-Associated
Colombia	Andean Community (CAN) MERCOSUR-Protocol of accession CARICOM-Observer state

12 SELA Report at 9; See also, article 21 UNASUR Constitutive Treaty.
13 See, article 5 UNASUR Constitutive Treaty.

Country	Regional and sub-regional membership
Ecuador	Andean Community (CAN) MERCOSUR-Protocol of accession
Guyana	MERCOSUR-Framework agreement CARICOM
Paraguay	Andean Community (CAN)-Associate MERCOSUR
Peru	Andean Community (CAN) MERCOSUR-Protocol of accession
Suriname	MERCOSUR-Framework agreement CARICOM
Uruguay	Andean Community (CAN)-Associate MERCOSUR
Venezuela	MERCOSUR-Suspended CARICOM-Observer state
Mexico (observer state)	MERCOSUR-Observer state CARICOM-Observer state
Panama (observer state)	
Trinidad and Tobago (proposed state)	CARICOM

The legal framework of UNASUR rests on a Constitutive Treaty signed in 2008 but which entered into force on March 11, 2011. Given their membership to other trading blocs, UNASUR members have been particularly careful to avoid duplicative efforts and potential conflicts that could affect any existing agreements between them, and have vowed to harmonize UNASUR with other regional arrangements.

Another important concern of UNASUR members has been the reduction of asymmetries that exist among the countries in the region, as a way to attain an equitable integration. Several formal declarations issued with the occasion of UNASUR high-level meetings have stressed the willingness and commitment of its members to create mechanisms of inclusion that level the playing field across the region by eliminating both structural and policy asymmetries.[14]

3. INTERNATIONAL DISPUTE RESOLUTION SOUTH AMERICAN WAY

A particularly interesting initiative of UNASUR members has been the establishment of a regional Centre for the Settlement of Investment Disputes. Initially proposed by Ecuador's president Rafael Correa in 2010 as an alternative to the World Bank's International Centre for Settlement of Investment Disputes (ICSID)[15]; UNASUR's arbitration center aims to offer a more transparent, accessible and balanced dispute resolution framework for investment-related disputes that arise among member nations.[16]

The proliferation of numerous multi-million dollar claims filed by foreign investors against several South American countries during the last two decades contributed to

[14] Permanent Secretariat of SELA (2017) link 9.
[15] See, ICSID (2017) link 10.
[16] See, Cancilleria (2017) link 11.

exacerbate the criticism levied on the traditional dispute resolution framework set up under the aegis of the World Bank during the 1960s. Since the filing of the first investment arbitration claim in 1972, ICSID has become the premier international forum for the protection of foreign investors.

The Center had registered 650 cases, as of December 2017, of which a significant number involved Latin American states as respondents.[17] The late 1990s witnessed an upsurge in the number of cases, the majority of which were logged against Argentina and later on Venezuela, in connection with economic activities of foreign investors in those countries.[18] Ecuador and Bolivia also became targets of ICSID arbitration claims but to a minor extent.[19] As the docket of ICSID grew, so did the criticism toward the system.

A common reproach was the perception of bias in favor of industrialized western countries and the corporations based in their territories. Moreover, given the close connection and economic interdependence between ICSID and the World Bank, some expressed concern that their access to credit from the latter might be affected by their posture toward the former.[20]

Another apprehension about ICSID was the cost and complexity of the proceedings before it, which often times required states to retain prohibitively expensive legal counsel to match their corporate opponents. This structural issue, some argued, hindered access to justice and efficiency.[21] Another criticism to ICSID was the absence of an effective appeal or review process that, unlike the existing annulment mechanism set forth in article 52 of ICSID Convention,[22] could help foster more predictability and consistency.

Both Bolivia and Ecuador denounced the ICSID Convention in 2007 and 2009, respectively,[23] and Venezuela followed suit in 2012. Even though many perceived these withdrawals as a tactical move by the governments of the denouncing countries to shield themselves from a series of imminent claims; at least in the case of Venezuela, foreign investors have continued to file claims under other (bilateral investment) treaty provisions therefore contributing to prolong the status quo. Ironically, the Venezuelan government has also trusted its legal defense to foreign – U.S. based – law firms.[24]

Almost seven years after it was initially proposed, UNASUR's Center for Settlement of Investment Disputes is yet to see the light of day.[25] Despite many efforts to make the proposal a reality, the state members of UNASUR have not been able to reach consensus regarding its framework. Notwithstanding, in January 2016, a high level group of experts

17 ICSID, The ICSID Caseload-Statistics (2018) link 12.

18 At the time of writing, the current figures are 54 cases filed against Argentina and 44 cases filed against Venezuela.

19 The total of cases filed against Ecuador is 14, and 4 against Bolivia.

20 Grant (2015) 6.

21 Grant (2015) 13.

22 ICSID Convention, article 52.

23 The depositary received Bolivia's notice of denunciation of the ICSID Convention on May 7, 2007, which pursuant to Article 71 of the Convention, took effect on November 3, 2007. The depositary received Ecuador's notice of denunciation of the ICSID Convention on July 6, 2009, which pursuant to Article 71 of the Convention, took effect on January 7, 2010.

24 Argentina, on the other hand, pursued a different strategy by assembling a hybrid team of public officials and private practitioners who were able to provide a cost efficient legal representation and amass a great deal of experience in representing state entities.

25 Sarmiento (2016).

that met in Montevideo, Uruguay to fine-tune the Rules and the Code of Conduct of Arbitrators[26] reportedly reached consensus on about eighty percent of the proposal.[27]

The most current version of the Rules addresses several important matters including the exclusion of certain types of disputes (health, environment, education, energy) from being resolved by arbitration unless the states expressly agree to include them.[28] Another important feature of UNASUR's Rules is the inclusion of a three-pronged approach to dispute resolution not just confined to arbitration (article 16 et seq.) but also including a facilitation mechanism (article 11) and conciliation (article 12). The Centre is also supposed to have a list of neutrals proposed by the member states, and subject to the Centre's Code of Conduct.

As an additional protection mechanism, the draft Rules also contain a provision allowing member states to require the exhaustion of local remedies as a precondition to the submission of the dispute to arbitration. On the other end of the spectrum, at the post-award stage, UNASUR's Rules incorporate an appeals mechanism geared to correct errors in the application or interpretation of the law, similar to the one that exists under the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) and the Working Procedures for Appellate Review (Working Procedures) of the World Trade Organization.[29]

The proposed UNASUR Centre certainly addresses many of the concerns raised by Latin American countries about the ICSID mechanism. If and when the Centre comes to fruition its effectiveness will depend on how it is implemented, the level of cooperation of its member states, and the receptivity of its users. Predictably, the idea of a South American investment dispute resolution mechanism has met some criticism mainly related to the perceived risk of political manipulation of UNASUR by its members.

Similarly to how some South American nations have accused ICSID for being tilted to favor of powerful transnational interests; those on the other side of the isle have likewise criticized the establishment of a Centre motivated by disgruntled disputants. Regardless of the validity of this concern, UNASUR's member nations have the duty to foster the credibility and legitimacy of this new mechanism not only to their immediate stakeholders but also to the world.

4. CONCLUSION

The two most recent efforts of regional integration in Latin America represented by ALBA and UNASUR have moved beyond the traditional economic agreements toward and more comprehensive undertaking that pays attention to other social and political issues of common interest to the member states. At least in the case of ALBA, the excessive reliance on the financial and political support of Venezuela was both the driving force behind it and also the main obstacle for its development.

In the case of UNASUR, the situation appears to be slightly different, and the structure more stable. In this regard, UNASUR members have also developed initiatives that go beyond the traditional scheme of a regional integration regime. A noteworthy initiative is the launching of a Centre for the Settlement of Investment Disputes, which purports to offer an alternative to the current mechanism sponsored by the World Bank. UNASUR's Centre

[26] Fach Gomez and Titi (2016).
[27] Fach Gomez and Titi (2016).
[28] Grant (2015) 28.
[29] Perez-Salgado, Perez-Lozada (2016) link 13.

has been subject to ample debate for more than seven years but it has not been launched yet. We will have to wait until that happens to assess whether the effort was worthwhile to the state members, its citizens and the foreign investors that engage in business with those states.

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Hedging Your Bets? – An Overview of the Legal Aspects of Hedge Funds

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Abstract: Hedge funds are a controversial element of the global financial system, as their activities can affect countries' economies to a great degree. Therefore, it is important to gain insight into their operation. The aim of the article is to give an overview of some legal aspects of hedge funds and starts with a definition of hedge funds, whilst also giving a historical overview of their genesis. The following parts outline the legal framework for hedge funds in the USA and the European Union. The conclusion is that regulation for hedge funds are flexible in spite of the reforms in the legal framework after the events of the financial crisis, which still makes them an attractive proposition for the 'high society' of investors.
Keywords: hedge fund, financial market, regulation, financial crisis, investment

1. INTRODUCTION

Hedge funds are a controversial element of today's global financial system and the word is amiliar across the world of institutional investors through the studios of Hollywood as well as within the context of small investors' modest rate of return. The influence of hedge funds does not come across as a surprise, since their history of operation marked with tremendous profits and dramatic losses. For long periods of time, the promised risky success was not available for small-scale investors e.g. in the United States it was not possible to invest in hedge funds below USD 1,000,000 (USD 250,000 later on). Nowadays, it seems rather reasonable to explore the characteristics of hedge funds in a more in-depth manner as the base rates of central banks[1] forecast only a minor increase in certain aspects. However, the task at hand is far from being simple, as the contextual definition of hedge fund already contains certain discrepancies.

2. CONTEXTUAL DEFINITION OF HEDGE FUNDS

Defining hedge fund is by no means easy, especially with taking into consideration that most definitions created by the legal literature use a negative approach in order to determine the concept. The word hedge fund originates from the expression 'hedged fund', which indicates a financial fund covering risks with certain investment techniques and instruments. Covering financial risks means taking a reverse position with the same volume (speculating to reverse market movements) contrary to the one taken previously with regards to a certain financial asset (investment instrument).

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[1] Lentner et al. (2015a), Lenter et al. (2015b).

For instance, in the case when a fund manager envisages an increase in the price of gold on the global market, it opens a long (purchase) position in that regard. In case it achieves a certain amount of profit with this position, in order to secure (cover) that profit, it opens a short (sale) position with regards to the same instrument, in this case, gold, whilst maintains the original position as well. Thus, the profit generated this way will be lower, since one of the two reverse trading positions will be a loss, however, the other position guarantees a remaining profit.

With regards to the expected market trends, the fund manager, after taking its position, assumes full risk and there is nothing to mitigate the loss as in the case of a wrong decision. When creating its trading approach based on its speculations, the hedge fund does not seek either diversification or risk mitigation, but, in order to achieve the highest possible profits, concentrates all of its financial resources on the establishment of a position speculated to be correct. In the case that the trading concept is successful, the fund manager can, and usually does strengthen its market position with additional financial instruments. Certain derivatives[2] with more risk, such as leverage, can be found among these instruments, since early successes reinforce the ideas lying behind a trading concept. Afterwards, however, the position is able to achieve such profit that would be unreasonable to be exposed to further risks, thus the fund manager commences reverse trading, the success of which will depend on the fate of the original position.

It is sufficient to a less extent to cover the profit in case the fund manager decides to dismantle or terminate the original position and, while maintaining or extending the original position, it is appropriate to open a reverse position created with higher turnover and backed with derivative instruments.

The hedge fund would be unable to achieve profits above market average in the case of cover all risks. This is the reason why the loan translation of hedge fund into Hungarian results in the wrong meaning as it would mean a reserve fund whilst the essence of hedge funds is to sacrifice reserves for the hope of a higher profit in the initial phase of positioning instead of providing coverage to certain positions. However, defining hedge funds as funds without reserves, a definition widely accepted by the legal profession, would also be incorrect as the management of these funds includes the opening of reserve positions, the extent of which could greatly differ. The ratio of short and long positions is established based on the fund manager's expectations, be it market growth or recession and furthermore, changes in the market and expectations relating to it can be traced down subsequently by altering the ratio of opened positions.

Defining hedge fund in a sectoral manner is also not appropriate[3] as it is comprised of, and used by, organizations on the market whose interests are dependent upon consumer confidence (or the lack thereof) shown towards hedge funds. Accordingly, hedge funds are defined as investment programs in which the fund managers are aiming for absolute return[4] with the use of certain investment opportunities whilst preserving the fund's capital at the same time. However, in essence, it is the exact opposite. The absolute return can only mean real profits in the case of the trading concept being an overall success otherwise it

[2] Derivatives, also known as derivative instruments, are investment instruments with a price that is dependent upon an underlying asset.

[3] Alternative Investment Management Association, AIMA's Roadmap to Hedge Funds (4th edn, 2012), 13.

[4] Absolute return means that the provider of investment services guarantees the profit to its clients independently of market performance.

results in a loss. This removes the possibility that the fund could maintain safe investments in all circumstances.

Thus, a hedge fund could be considered as an investment being able to provide significant return paired with high risks, even against market trends, usually for well-capitalized clients. It does not limit its investment policy in any form, and the fund manager manages its own capital in the fund as well, thus it takes the same type and extent of risk as its clients. The use of high-risk items (usually derivatives) during the management process, is a widespread practice. The fund's hedging activity solely functions in order to safeguard profits but there is a higher level of capital risk. The legal treatment of hedge funds may vary widely in a global context.[5] In the course of its investment activities, next to risk management, hedge funds use leverage and derivative transactions as well, and in most cases, it rewards fund managers with performance fees.[6]

3. THE HISTORY OF HEDGE FUNDS

The history of hedge funds can be traced back to 1949, when Alfred Winslow Jones[7] established his investment company, which still has a significant effect on the industry's functioning even after 60 years of its establishment. Jones established his company by recruiting a clientele comprised of ninety-nine investors and thus did not fall under the jurisdiction of the Investment Company Act of 1940 which puts investment companies with a clientele of at least one hundred investors, and asset managers under the authority of the SEC. The company took high risks due to the concentrated nature of its market positions and was the first to apply short position trading[8] and leverage.[9] Jones also managed his own capital in the fund, working with a 20% performance fee. The idea of managing own capital in the fund paired with high performance fees has been deemed as an industrial fundamental principle ever since as these factors are creating harmony between fund managers and investors. Jones pioneered the technique of combining purchase (long) and sale (short) positions in a way that it eliminates systematic risk in the market whilst maximizing risks projected towards certain investment instruments. The reason for this was that system-wide market timing was not one of Jones's strengths but, as he was aware of this, he took long and short positions to an equal extent, however, only one with regards to a given investment instrument. Naturally, he based short positions on securities he regarded as overvalued,

[5] See Shadab (2013) 141.

[6] See Ashworth (2013) 655–56.

[7] Alfred Winslow Jones (1900–1989) started his carreer as a sociologist and financial journalist. He finished his university studies at Harvard and Columbia. His name is strongly bound to the establishment and operation of the first prototypes of hedge funds. He had dealt with professional investments previously but he became well-known in 1966 following a comprehensive review of his approach and activities in Fortune magazine. See Connor and Woo (2004) 12.

[8] Short position means directional trading where the fund manager sells the shares of borrowed stock and expects that the price of the stock will decrease. When the price of the stock decreases, the fund manager will purchase the shares. Thus short position is a type of speculative trading, during which profit is earned in case the price of the investment instrument decreases. The word short originates from the fact that previously such transactions could only be made with short expiration deadlines. Consequently, purchase positions are indicated as long positions.

[9] The advantage of using leverage is that it can multiply the profits generated by the investment, however, the same applies to losses as well. This possibility was first utilized by Alfred Winslow Jones during the management of his hedge fund.

while he opened long positions on the undervalued ones. Therefore, his strategy was based on only considering the expected future performance of certain shares, while being able to act independently of market trends. Furthermore, he made use of the possibility to tie only a smaller portion of his trading capital by using leverage, thus could trade on a higher volume simultaneously with the taking of higher risk. Another one of his innovations was that he did not manage the fund alone but tried to increase efficiency by involving external experts and thus laid down the theoretical foundations of multi-manager hedge funds whilst at the same time created the prototype of fund of funds[10] investing in hedge funds.[11] However, from the end of the 1960s,[12] hedge funds that applied this same strategy did not achieve successes, as, at that time a permanent growth rate characterized by the Nifty Fifty[13] shares emerged on the stock market.

Nifty Fifty, according to United states' stock market jargon, indicates those shares which had high capitalization[14] in the 1960s and 70s and their successes were recognized with a P/E ratio[15] above 50 on the market.[16] Popular and well-known publicly traded companies[17] were categorized in this group and include such companies as Coca-Cola, Pepsi Cola, McDonalds, General Electric, IBM and Wal-Mart. Companies investing in their shares achieved, at that time, a return rate of 29.65% in 29 years.

The permanent growth rate on the stock market did not favour the long/short strategy developed by Jones and hedge funds could not reach the rate of return achieved by the growth of the Nifty Fifty shares. From an economic point of view, this underlines that the long/short strategy of Jones, still being applied by hedge funds to this day, was based on reverse positions which were contrary to certain market trends. In order to catch up with the return rate of the Nifty-Fifty, funds started to apply the long strategy created with leverage

[10] The fund of funds is an investment fund which invests in other investment funds. Contrary to other fund managers, the managers of fund of funds do not invest in directly accessible instruments. The advantage of this is that, indirectly however, but opens the possibility to invest is instruments which would otherwise be unaccessable on local markets.

[11] Ashworth (2013) 675.

[12] See Connor and Woo (2004) 13.

[13] See Fesenmaier and Smith (2002) 86.

[14] Starting in November 3, 1995, the Nifty 50 index, the leading index of India used the sam name.

[15] The Price/Earning indicator is the ratio of the price of a given share and the annual profit generated by that given share. The results of the last 12 months are calculated and adjusted with stock split and calculated with the rates of the initial period. The market average usually shows a value of 15 on the long run.

[16] At the peak of the stock market cycle starting in the 1960s the P/E ratio of Avon in 1972 was 65 and Polaroid was 91. During the stock market downfall in 1973, the price of Polaroid shares dropped 91%.

[17] A similar umbrella-expression is blue chip, meaning the most reliable and steadily profitable companies. The expression blue chip originates from poker, where the most valuable chip is the blue one with 25 dollars, while red is 5 and white is 1. According to stock market legends, this expression was already used by Dow Jones Newswire during the 1920s. The Dow Jones Industrial Average shows the overall performances of the 30 biggest companies from May 26, 1986. It usually includes blue chips. The index is not stock market capitalization-wighted, but exchange rate-weighted, which means that the exchange rates of the companies included in the index are combined then divided with a ratio which includes stock split as well. In 2013 an exchange rate change of a dollar meant a 6.42 points change in index points.

instead of the long/short strategy. This strucked back later as the 1972-74 stock market crash caused significant losses for hedge funds using this strategy. The said market crash resulted in a 10-year decline during which many hedge funds shut down their operations. In 1968, there were 140[18] registered hedge funds in the United States but this number had decreased to 68 by 1984.[19]

The Tiger Fund, managed by Julian Robertson[20] in the 1980s, was the next fund which spurred interest towards hedge funds by achieving a return rate of 43% in 5 years. The secret of its success was the application of a new strategy known as the global macro strategy which was applied by Roberts with leverage in order to maximize profits. The global macro strategy makes investment decisions based on the analyzation of macro-economic[21] and political tendencies and thus this strategy does not make investment decisions in a corporate or sectorial context but is based on a supranational, global and (national) economical view. Roberts, while analyzing foreign exchange markets in 1985, recognized the exhaustion of the USA dollar's growing tendency compared to Japanese yen (JPY) and thus shaped his investment policy by puchasing call options on the cross rate of certain european currencies, Japanese yen and USA dollar. Cross rate is the numerical expression of the value of two currencies compared to each other. In case 1 USA dollar is worth 300 Hungarian forints (HUF), the cross rate of USD/HUF is 300. A price increase of the said currencies in relation to the USD results in a significant increase in the the value of the call options tied to them. The value of the call options, at that time, were low compared to the currencies functioning as underlying assets and furthermore, the market expected the strengthening of the USD at that time. The increase in the option value resulted in a higher than usual profit for the hedge fund. It has to be taken into account that the yield on the call option becomes in itself significant in the case when profits are achieved as in the course of the transactions the parties apply large-scale leverage. It is not a surprise that hedge funds are envied actors of the business world as they are able to provide exceptionally high profits for their exclusive cliente. Hedge funds are also, at the same time, the target of controversy as they often collaborating in major transactions which were heavy for the public purse, including the development of speculative positions against certain national currencies, leading to well-known currency crises.

György Soros and his managed funds are closely related to this type of activity. The most well-known example is the Quantum Fund and its speculation against the British

[18] See: Hedge funds, Leverage, and the Lessons of Long-Term Capital Management Report of The President's Working Group on Financial Markets. p.1. The Department of Treasury, the Board of Governors of the Federal Reserve System, the *SEC* and the Commodity Futures Trading Commission prepared a report on *hedge funds* and the LTCM scandal for the president of the United States. In the report they reviewed, among others, the historical background of the industry. According to a 1968 *SEC* report in that year 140 *hedge funds* existed.

[19] See Connor and Woo (2004) 13.

[20] Julian Robertson (1933–) finished his business administration studies at North Carolina University in 1955. He worked as a broker for Kidder, Peaboady and Co. for 20 years. In 1980, he established Tiger Management Group and during his active years he acquired the moniker 'Wizard of Wall Street' after securing an annual return rate of 32% between 1980 and 1996. His favourite saying was 'let us select the best 200 publicly traded companies and play for their increase and select the worst 200 and with short sales speculate on their decrease. In case the best 200 does not perform better than the worst 200 it is time for us to look for another job'.

[21] Macroeconomics determine the functioning standards of economic systems, contrary to microeconomics, which describes the mechanisms of unit-level economic collectives.

currency (GBP) and the Thai baht (BHT), where the Quantum Fund applied the global macro strategy. In 1992, Quantum Fund speculated on the weakening of the GBP and took advantage of the crisis of the European Exchange Rate Mechanism.[22] At that time, it opened short positions with high leverage, achieving an estimated profit 10 billion USD. The English central bank was not able to protect the exchange rate of the GBP – even with a significant interest rate increase[23] and the GBP cross rate decreased from 2.95 to 2.4 compared to the German mark (DM). The 16th September 1992 went down in the history of English economy as Black Monday. Market estimates suggest that this speculation resulted in a loss of 3 billion GBP to English taxpayers. It also established the long-term negative connotation of Soros-managed funds. The next high-profiting transaction was against the BHT, where the Soros-managed fund speculated that the government of Thailand would not be able to protect the fixed exchange rate[24] of the BHT compared to the USD (the cross rate of 25). In April 1997, Soros opened lucrative positions based on the devaluation of the BHT[25] and on 2nd July 1997, following an unsuccessful effort to protect their national currency, the Thai government had to let the fixed exchange rate float free. The free float phenomenon[26] in financial terminology literally lets the free flow of events. The consequences were once again suffered by the public, however, unlike the British scenario, this speculation was directed against a financially unstable and economically unprepared country. The British speculation involved the serious devaluation of national currency (18.6%) but it was not a fatal blow to the UK economy. However, the Thai speculation resulted in the collapse of the national economy and the total elimination of the BHT's stability. Consequently, the Thai central bank had to turn for assistance to the International

22 The European Exchange Rate Mechanism (ERM) is an international payment system established by the European Economic Community on the 13th March 1979 with the purpose that the European Economic Community could establish ERM as a part of the European Monetary Union. The ERM paved the path for the introduction of the euro. The aim was to decrease the exchange rate fluctuation between currencies and bring the member states of the European Economic Community (later, the European Union) closer to financial stability. The targeted aim was achieved in January 1, 1999 with the introduction of the euro

23 See Dhar (2016). In September 16, 1992 the English central bank raised the base interest rate from 10% to 12%, and to 15% on the same day, following the unsuccessful protection of the pound's exchange rate during a 1 billion pound intervention. That was the time when Soros said 'go for the jugular'.

24 The aim of fixed rate or pegged rate exhange rate systems is the stabilization of the national currency by tying it to another national currency, the basket thereof or e.g. gold. This way the position of the given national currency could be stabilized in the international financial markets. However, a prerequisite of this is that the national bank protects the currency with the constant sale or purchase thereof. The downside of fixed rate is that it prevents independent monetary politics and only a part of the national bank's currency reserves can be used for the protection. In the case that the national currency is under pressure from price-decrease then with a capital bigger than the currency reserves then the forfeiture of the the fixed rate can be achieved in the financial market.

25 See Forex Illustrated (2013). In July 1997 Soros warned the people of Thailand of the possible price-decrease of their national currency and the crisis emerging as a consequence. However, the Thai national bank intervened with 7 billion US dollars just when the Thai baht became stronger compared to the US dollar, turning the previous investments of Soros into a loss.

26 In the case of a *free floating* exchange rate system, the national bank does not tie the exchange rate of the national currency to another currency or the basket thereof, but, rather to the contrary, it lets market demand and supply determine the exchange rate of the national currency.

Monetary Fund (IMF) who approved the loan package requested by Thailand. However, strict economical and social constraints had to be implemented by the Thai government as a condition of the loan. By December 1997, the exchange rate of the BHT increased to USD/BHT 55, when the management of Quantum Fund decided to close its positions, earning a profit of USD 790 million.

However, not all transactions carried out by hedge funds resulted in such notable profits in the 1990s and some funds suffered huge and considerable losses. Quantum Fund and Tiger Fund both lost USD 2 billion during these times. The Soros-maganged fund suffered massive losses due to the Russian stock market crisis while the fund managed by Roberts speculated the devaluation of the JPY. Both strategies failed as the positions were established contrary to future market movements. The assessment of the United States infocommunication sector, the aptly named dot-com sector, became exhausted in 2002 and was a particular sector that caused headache to hedge funds and featured significant investments of the two above-mentioned funds. Quantum Fund lost USD 3 billion with the opening of short positions while the shares of the dot-com sector were flying high. The problem was not with the strategy direction, but the timing. The subsequent events of the market confirmed the overvaluation of the shares appearing in the sector. Likewise, it was correctly assessed by the Tiger Fund that the increase in the dot-com sector was unstable, however, it applied a more refined and complex investment strategy by the simultaneous opening of short positions on dot-com shares and long positions on shares from other, more traditional industry sectors. In their case, however, wrong timing proved to be fatal, as the fund had to shut down its operations in March 2000, following the complete loss of their creditors' confidence and the withdrawal of the invested capital. It is ironic that an amount of profit, never seen before, could have been achieved if the above-mentioned positions were opened by the hedge funds at the right time.

The most emblematic and important event in the history of hedge funds was the fall of the Long-Term Capital Portfolio L.P. managed by the Long-Term Capital Management L.P. (LTCM). This hedge fund was established in 1993 by Nobel-Prize winning mathematicians and economists[27] and was led by John William Meriwether (1947–),[28] the former vice-president and head of the stock market department of the Salamon Brothers investment bank. The fund wished to apply a strategy exploiting the opportunities of very low extent arbitrage[29] and is also known as the quantitative strategy.[30] The question arises how a scientifically backed and seemingly successful idea could be a failure in the practice of

[27] Robert Cox Merton (1944–) and Myron Samuel Scholes (1941–) were professors at Harvard and Stanford who received economic Nobel prize in 1997 for elaborating the model for determining the value of derivatives transactions. Fischer Black passed away in 1997 thus could not receive the Nobel prize, however, the Noble Committee mentioned Black and his contribution to the model. The Black-Scholes model provides framework for the valuation of sale and purchase options.

[28] It is worth mentioning that investment activities of John Meriweather have not been successful ever since. In 2002, he established another hedge fund which went bankrupt as the result of the 2007 subprime crisis.

[29] Arbitrage is a financial instrument which is traded on different markets and on different values. Consequently, in case of the establishment of simultaneous selling and buying positions it can provide safe investment opportunities.

[30] During quantitative investment strategies a large amount of financial data is being examined in a fast manner, which is able to provide quickly tradeable information to the one who applies the strategy.

financial market mechanisms? The idea was based on the convergence theory[31] used in mathematics and the fund took advantage of the interest rate difference between bonds issued by certain member states in the European Union. This strategy was based on the assumption of persistently low volatility[32] and high liquidity. However, they could only ensure big profits with the application of high leverages next to low interest rate differencies, therefore the hedge fund, next to its capital of USD 4.8 billion, requested a loan of USD 120 billion and thus the investment exceeded the fund's own assets by twenty-five times, indicating the use of a surprisingly high volume of external sources. However, as this investment capital was increased with leverage, the nominal exposure[33] of the fund reached USD 1200 billion. This economic model was viable until the outbreak of the Russian stock market crisis in 1998.

However, after 1998, low volatility increased and liquidity decreased simultaneously and this was time when the two basic conditions of the hedge fund's functioning model collapsed and both started to work against it. The dramatic increase of volatility resulted in the hedge found not being able to close its positions with a low rate of loss. Consequently, it was not able to pay the loan of USD 120 billion back to the lenders (banks) and it lost its credit solvency. Thus, on the weekend of 19th–20th September 1998, the FED – with fourteen financial institutions – organized a liquidity loan for the hedge fund in order to save LTCM from the forced sale of its existing positions. The situation where the central bank of the United States, for the sake of only one fund, directly mediates between a hedge fund, on the edge of solvency, and other market actors is rather controversial. The reason behing this unusual step by the FED was based on the prediction that the bankruptcy of LTCM would directly endanger certain financial institutions providing sources to it beforehand and would lead to system-wide market recession.

The popularity of hedge funds remained undiminished, despite the difficulties and highlighted huge losses. This is well-illustrated by the USD 11 billion investment by one of the world's biggest institutional investors, the California Public Employees Retirement System (CALPERS)[34] in certain hedge funds 1 year after the fall of LTCM.[35] By the end of the 1990s, the dynamic growth created a new type of method. Hedge funds started to invest in other hedge funds–a fund of funds in the financial terminology. Nowadays, however,

[31] The basis of convergence theories is the assumption according to which the value of various associated variables are in the same direction or level.

[32] Volatility means the extent of the temporal movement of a given financial instrument. It indicates the zone in which the the financial instrument moves in a given time period. A large movement zone means a greater volatility, and vica versa.

[33] Nominal exposure means the overall possibility of financial losses which can be suffered by the investment institution with taking into account the maximum losses its positions can generate. The concept is used to determine the biggest possible loss which can be suffered by an investment fund (or other institution) with regards to the capital managed by it.

[34] CALPERS is the pension fund of the state of California, and one of the biggest institutional investors in the world. Its investment portfolio is complex, ranging from venture capital investments to derivatives based on shares issued by publicly traded companies. For Hungarian lawyers and economists, it could be strange that one of the biggest institutional investors in the world is a state-owned pension fund, however, in the United States pension funds try to increase the value of their savings with bigger capital and a more active approach on the market.

[35] See Connor and Woo (2004) 17.

funds of funds do not necessarily operate as hedge funds, but in a differently controlled[36] and regulated institutional form. In the investment world, it is common knowledge that the funds of funds only work with direct investments, e.g., by acquiring a certain amount of shares in hedge funds, therefore, investing in hedge funds nowadays became an option for smaller investors as well.

Diversification[37] can appear in in the case of funds of funds operating as a hedge funds in two different forms. The first divides its capital between hedge funds applying different investment strategies, while the second form does the same between hedge funds with identical investment policy.[38] It is not uncummon for certain funds investing in hedge funds to go public. The Alternative Investment Strategies Ltd.[39] in 1996 was the first hedge fund investing in other hedge funds which decided to go public in the London Stock Exchange. It was involved due diligence experts as well as new investors, resulting in an increased extent of transparency as in general hedge funds disclose only a small amount of information regarding their investment policies. Therefore, funds investing in hedge funds combine the efficiency and knowledge of hedge fund managers with the criteria of increased transparency, which is expected in case of a wider circle of investors. However, the advantege of increased transparency increases transaction costs for the clientele as well, as it is incorporated in the budget system as a price-increasing factor. This leads to the dramatic increase of investment costs based on the cumulative surplus of competency expressed on two levels, since next to the expertise and knowledge of the hedge fund's management the costs of management add up as well. For example, a 2% base price and a performance fee of 20%,[40] common among hedge funds,[41] then in the case of a fund of funds a 4% base price and a performance fee of 40% might encumber the gross rate of return. The high costs of management can be reduced, however, only to a small extent. The performance fee of 20% (40% in case of fund of funds) applies only to the part of the total annual return which exceeds the one in the previous year.

4. THE STRUCTURE OF HEDGE FUNDS

The most efficient way to understand the special structure of hedge funds is by taking into consideration that their main goal is to be exempted from certain regulations applicable to institutional investors. This special status is required in order to avoid certain regulatory and supervisory authorities and their willingness to treat hedge funds similarly to other investment funds and to increase transparency for a wider circle of investors. Hedge funds wish to constantly reinforce their exclusive characteristics by reserving a degree of flexibility in taking their decisions, which other investment funds do not possess and furthermore, they wish to hide their investment strategies from the public eye as long as possible. Simultaneously, they wish to maintain the most motivating and stimulating

[36] Zéman et al (2014) 217–21.

[37] Diversification is a process during which the managed capital is allocated with the use of several investment instruments, decreasing the risks of that specific investment instruments. Diversified investment portfolios do not ensure avoiding losses, however, they decrease extremely high risks to the level of market or sectorial systemic risk.

[38] Investment policies require the appropriate accounting policies. For a method for their development, see Zéman et al. (2012) 106–17.

[39] See Connor and Woo (2004) 17.

[40] See Shadab (2013) 152.

[41] Ashworth (2013) 658.

remuneration system for their fund managers as another exclusive characteristic. These characteristics stand opposed to the requirement of reliable, transparent and prudent investment policy requested by supervisory authorities and the consumers. In order to unlock these two seemingly contrary interests, hedge funds seek to partially or completely avoid certain regulations mentioned above. Most hedge funds operate in the United States and they all seek to be exempted from the Investment Company Act of 1940 as it creates a substantial amount of administrative burden as well as disclosure obligations, furthermore, it limits the use of certain investment techniques such as leverage or concentration. However, the Investment Company Act of 1940 itself provides certain loopholes for companies to be exempted from its provisions, as in the case of a clientele of less than a hundred investors, the criteria mentioned above does not have to be fulfilled. Accordingly, both the Quantum Fund and the Tiger Fund followed Jones's footsteps and were established with the involvement of 99 investors. From 1996, the act was amended sothat the number of investors may increase above one hundred in the case of qualified purchasers.[42] In order for this to happen the qualified purchaser[43] has to have a capital of at least USD 5 million as a private individual while the institutional investor has to manage a capital of at least USD 25 million.

In order to hide their deal strategies (ratio of long/short positions, leverage ratios and derivatives transactions) involving proprietary trading[44] from the public eye, hedge funds seek to be exempted from the provisions of the Securities Act of 1933, which sets forth certain disclosure and registration obligations. It is also important that such data does not get in the hands of competitors as a result of certain statutory requirements. Furthermore, by being exempted from these obligations, hedge funds save a considerable amount of compliance costs. However, hedge funds have to accept that they are not allowed to raise capital publicly, only in accordance with the rules applicable to the private placement process. Furthermore, the number of investors with a capital below USD 1 million and an annual income below USD 200,000 have to be kept under 35.[45] In order to operate efficiently and comply with statutory requirements simultaneously, within their necessarily limited clientele, hedge funds have to concentrate on investors with large capital. The only way to grow is by having a circle of investors capable of providing a large-scale capital for the fund as the potential lying in capital allocation decreases due to the narrow circle of participants. In the context of regulations enacted after 1996, this means that the most efficient hedge funds limit the number of those participating investors which are limited by the law to the minmum. It is obvious that belonging to a private circle creates a massive

42 Section 51/A of *Investment Company Act of 1940.*

43 Bárczi and Zéman (2015) 101–08.

44 Proprietary trading means that a company issues its own shares for its employees trading with shares and provides the possibility of leverage for traders as well, thus the company can take the profit of the entire transaction (contrary to the maximum brokerage fee of 1–2%). However, the overall risk (multiplied in case of leverage) with this method is also taken by the company. Following the 2008 subprime crisis, the proprietary trading activities of investment banks was significantly limited in the United States (down to 3% of the company's own capital in accordance with the Dodd-Frank Act).

45 The regulations governing the private placement of shares limit the issuance or purchase of shares to a narrow circle of investors in a global context. Typically, irrespectively of the characteristics of the private placement process, such placement can occur with limited value and in limited numbers. Simultaneously with the determination of the narrower scope of owners or investors, the volume of the potential sources to be allocated decreases as well, while less obligations arise with regards to disclosure towards the public.

advantage, as these investors represent the ones with smaller capital, however, due to their luck or good sources of information they are able to achieve big profits – they are given the chance to play with the big guys.

Most hedge fund managers also seek to be exempted from the registration requirements set forth by the Investment Advisers Act of 1940 – this is possible if the fund manages a capital smaller than USD 150 million in the form of a hedge fund or if it complies with the criteria of being a foreign private adviser.[46] The act also sets forth that the adviser has to register at the Securities & Exchange Commission (SEC). In this case, however, the SEC will be entitled to request certain information and supervise the activities of the manager. Furthermore, by registering, the fund manager would accept the limitation of its own remuneration as it could only receive compensation proportional to its performance. Thus, it would have to let go of the base price determined as a percentage of the total assets managed by it (usually 1-3%), which is due regardless of the fund's performance. Nevertheless, there are hedge fund managers who register with the SEC in order to gain the additional trust of investors.

From a taxation point of view, hedge funds are distinguished from traditional investment funds – the institution hedge funds are the closest related to – by the company form they are operating under, and their place of registration. Hedge funds are established as partnerships or limited liability partnerships[47] in order to avoid double taxation applicable to stock corporations.[48] In the case that the company would pay the dividends from the net profit, the clients would have to pay dividend tax as well.

Furthermore, two-third of hedge funds operating in the United States[49] are registered as offshore companies outside the US in order to exploit the benefits of lower corporate tax for the sake of additional tax optimization. Interestingly, not all the hedge funds operating in the US are registered in well-known tax havens such as the Cayman Islands, British Virgin Islands, Bermuda or the Bahamas, but also in Luxembourg and Ireland.[50] These two European states, contrary to the US, allow the advertising of hedge funds and do not limit investment capital. Furthermore, they allow hedge funds to go public and issue their share via public placement.[51] Ireland, for instance, within the sphere of the Qualifying Investment

[46] Prior to the Dodd-Frank Act, 'foreign private adviser' was determined by the applicable law as an investment adviser (with regards to the sale and purchase of shares) having less than fifteen clients from the USA and not performing such advisory activities in the USA. The Dodd-Frank Act has made these limitations even narrower. With respect to the limit of 25 investors, the clients of private funds have to be taken into account as well, furthermore, it should have no registered seat in the USA and does not perform advisory activities for registered investment and development companies. Along with these conditions, only a small-scale fund can be operated as a foreign private adviser instead of a hedge fund, just as it could have been targeted by the legislator of the Dodd-Frank Act.

[47] See Shadab (2013) 153.

[48] In the United States, civil law governs 'partnerships', the establishment of which does not necessarily require strict formalities and official registration. However, in case of hedge funds, partnerships are more like European business organizations with a strong cooperative (partnership) nature, like a general partnership. These similarities also manifest in the fact that while the members of general partnerships have unlimited liability with regards to the debts of the company, only limitied liabilities can be found among the members of limited companies.

[49] See Shadab (2013) 155.

[50] See Browne (2012) 2.

[51] See Browne (2012) 7.

Fund (QIF),[52] allows the advertisement of hedge funds and determines minimized restrictions with regards to their investment policy. The more flexible regulatory framework means that, based on its own expectations and willingness to take risks, the hedge fund manager can freely use leverage while its only obligation being disclosure via the fund prospectus towards investors regarding the extent of leverage applied and describing the way it is used. In Ireland, the regulation is narrow, it only includes counter-party risk[53] and limits investment (to a maximum of 50%) in certain unregulated funds.[54] It is not a coincidence that according to a 2011 survey 63% of European hedge funds and 40% of hedge funds operating globally are having their registered seat in Ireland.[55]

5. THE REGULATION OF HEDGE FUNDS IN THE UNITED STATES

The desire towards the system-wide regulation of hedge funds in the United States emerged with the fall of the LTCM.[56] However, more than ten years had to pass before the first substantive actions were taken. The 2007–2008 subprime mortgage crisis once again raised awareness of the role of hedge funds and the extent to which they could endanger financial stability, even if they were certainly not the central point of this particular crisis. During the crisis, the question arose whether hedge funds are able to increase and spread potential risks across the entire financial system.

The roles of certain institutions financing hedge funds (prime dealers)[57] are usually taken by the biggest investment banks. These banks[58] provide loans which form the basis of the increased trade capital of hedge funds. Increased trade capital is used by hedge funds in derivatives transactions with the possibility of multiplying the profit (or loss). However, it has to be taken into account that hedge funds, typically to proprietary trading activities, put the overall capital at risk. This is different from clients taking all the risk of the brokerage activities of investment banks and companies. The sole risk factor investment banks have to take is the loss of the brokerage fee in case their transactions fail. With the involvement of

[52] Hedge funds meeting the two following criteria can be deemed as Qualifying Investment Funds (QIF): It determines savings above EUR 100,000 as a minimum amount for investment and only manages the investments of investors qualifying as professional investors in accordance with Annex II of Directive 2004/39/EC (Markets in Financial Instruments Directive) and backed with MIFID tests underlining their expertise. See Browne (2012) 2.

[53] Counter-party risk is a contractual risk which originates from certain liquidity problems arising among contractual partners. For example, in case the fund manager purchases a block of shares from its partner being under the pressure from risks arising with the default of the transaction of shares. Real risk originates from the deficiency of regulations, since in a reliable environment there are institutional warranties safeguarding the fulfilment of certain obligations, for example with the involvement of clearing houses.

[54] Funds falling outside of the scope of regulations applicable to hedge funds.

[55] See Browne (2012) 1.

[56] See Ashworth (2013) 669.

[57] Interestingly, the expression '*prime dealer'* i.e. a financial institution directly financing a hedge fund, is not translated to Hungarian by Act XVI. of 2014 but is used in its original English version.

[58] Lentner (2013).

clearing houses, the non-performance risk of contractual partners participating in the deal can be reduced to a minimum on the stock market (or on other regulated markets).[59]

However, in the case that the hedge fund loses its increased capital, the investment bank, as the institution financing the hedge fund, can record a major loss as well. In the case it is applied on a large scale by investment bank, and, due to other reasons, a crisis has already emerged on the markets, this financing method has the potential to put the entire market in danger. There was a good chance for such systemic risk to appear after the fall of the LTCM.[60] However, it was resolved by creating a controlled insolvency situation with the help of the rescue package, thus the stability of the financial system was maintained. It was important achievement, as the earthquake-like fall of the hedge fund could have caused a domino-effect the collapsing the investment banks which would have endangered the liquidity of commercial banks.

In order to achieve higher profits, the investment banks have used their trading capital for proprietary trading and thus used short-term loans borrowed from commercial banks to finance hedge funds. However, the investment banks would not be able to pay back, these loans to the commercial bank in case the hedge funds did not repay their loan to them in the first place. In case the FED did not intervene once again in 2008 following the bankruptcy of Bear Stearns, the chain reaction described above would have materialized as a real threat.

The new act seeks to eliminate situations where such measures have to be taken at the cost of taxpayers. Therefore, the main goal of the Dodd-Frank Wall Street Reform and Consumer Protection Act (commonly known as the Dodd-Frank Act) was to strengthen financial stability. The proposed legislation had already been presented by the Obama Administration in July 2009 however, only entered into force on July 20, 2010. Following several amendments, Barney Frank (the then chairman of the Committee on Financial Services) represented the proposal front of the U.S. House of Representatives, and at that time the chairman of the Senate Banking Committee was Chris Dodd. In recognition of their main role played in the creation and enactment of the act, the name of the two politicians was included in the title. The title of the act is meaningful, as it promotes the strengthening of system-wide financial stability.[61] In order to achieve this target, the act promotes the increase of accountability and transparency in the financial system and to that end it established the Financial Stability Oversight Council (FSOC) as an intergovernmental organ and the Office of Financial Research under the control of the U.S. Department of the Treasury, two supervisory authorities with monitoring activities and intervention rights. The title of the act also suggests that the 'too big to fail' concept has come to an end. However, for taxpayers the protection from the burden of similar rescue packages in the future is what matters the most as it is common knowledge that the costs of the state's rescue packages are deducted from the federal budget and indirectly from the pocket of taxpayers. Nevertheless important, the act promotes the protection of consumers from abusive financial service practices.

[59] The function of cleaning houses is to decrease to the minimum the contractual risk for its members by entering into the contract instead of its member and ensuring the fulfilment of the obligation. For this purpose, cleaning houses establish and operate a system of rules being able to secure the fulfilment of certain obligations in case of significant market shifts as well.

[60] Riviére (2011) 265.

[61] An Act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to put 'too big to fail' to an end, to protect American taxpayer by ending bailouts, to protect consumers from abusive financial services practices and for other purposes.

Basically, the Dodd-Frank Act affects the operational framework of hedge funds in three different aspects. First, it sets forth that hedge funds managing a capital of USD 150 million or above have an obligation to register[62] with the U.S. Securities and Exchange Commission (SEC).[63] Thus the managers of the hedge funds were no longer able to decide on their own whether they wish to avoid supervision and focus only on clients with a bigger capital or limit the number of investors. The obligation to register with the SEC creates a substantial amount of admininstrative burden for the fund manager. Among others, the fund manager has to keep certain records in order to evidence in case of a SEC investigation the fact that in the course of its investment activities it excluded conflict of interest between executive officers and the fund. In order to meet with transparency requirements set forth by the Dodd-Frank Act hedge funds have to employ chief compliance officers. The task of the chief compliance officer is to work out and operate a compliance program which gets in the spotlight during periodic SEC inspections or investigations. However, the competence of the SEC increased even further by having the right to oblige mid-sized hedge funds to register. Furthermore, the SEC might request additional information and reports from other hedge funds as well.

The Dodd-Frank Act brought hedge funds under direct regulatory supervision with a new method, the commodity pool, which usually mandates external advisers (commodity pool adviser)[64] to manage the raised capital. Hedge funds can be deemed as institutions investing in stock market transactions and have as their sole purpose the enhancement of leverage by combining and managing investments as a single unit. These units became the centre of interest since certain traders (Commodity Futures Traders, Commodity Futures Operators) were obliged to register with the Commodity Futures Trading Commission (CFTC) for the successful monitoring of systemic risk in future tradings.

The Jumpstart Our Business Startups Act of 2012 (JOBS) lifted the previous restriction, according to which hedge funds were only allowed to seek and advertise themselves to qualified investors[65] or qualified institutional investors. Section 201 of the JOBS Act exempts hedge funds from this limitation as it amends certain provisions of the Code of Federal Regulations relating to the functioning of the SEC in a way that it permits hedge funds to seek investors in a wider sphere, provided that the hedge fund registers with the SEC in accordance with Formula D[66] of the JOBS Act. Consequently, the issuer of securities is able to seek any kind of investor and is allowed to advertise itself to anyone, however, can only market to investors defined as qualified investors by the JOBS ACT.

[62] Ashworth (2013) 684.

[63] Ashworth (2013) 654.

[64] Commodity pool advisor is a private individual or a company managing a fund investing in commodities. Commodity pool operator is the company providing administrative and depository services to the fund investing in commodities.

[65] Irrespectively of loans and the primary residential property, a private individual (or a private individual together with their spouse) has a net wealth of *USD* 1 million at the time of the registration. The second option is that the client had an annual wage of minimum USD 200,000 in the last two years and is likely to acquire the same amount in the upcoming years, or together with his/her spouse they had an annual wage of USD 300,000 in the last two years and are likely to acquire the same amount in the upcoming years as well.

[66] The Securities Act of 1933 provides two opportunities for a company in case of the placement of shares. It can register with the SEC in accordance with a strict procedure, or by applying Sections 504, 505 and 506 of the Act it only fills Form D out, evidencing the fulfilment of one of the three requirements.

6. THE REGULATION OF HEDGE FUNDS IN EUROPE

Europe chose a different path in the regulation of hedge funds as the United States. European Union lawmakers realized in 2010 that controlling the growing number of hedge funds is an impossible mission, and the only way to successfully regulate their functioning is through the implementation of certain rules applied to fund managers. For this purpose, Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM Directive) was created. The AIFM Directive also contains certain exemptions, according to which alternative investment funds[67] managing a capital below the threshold of EUR 100 million and funds managing an unleveraged capital below the threshold of EUR 500 million and not granting redemption rights to investors for 5 years are exempted from certain provisions of the AIFM Directive. Based on the AIFM Directive, fund managers are able to choose from two different functioning models. The first is a traditional functioning model under Directive 2009/65/EC on Undertakings for the collective investment in transferable securities (UCITS). The other model has to function in compliance with the rules set forth by the AIFM Directive.

In March 2009 the AIFM Directive set forth certain targets[68] with respect to the alternative investment fund industry. The first and most important is macro-prudential risk management. In the context of alternative investment funds, macro-prudential risk means systemic risk during which the collection of macro-prudential data takes places in a coordinated way and, in accordance with the lawmakers' will, data is processed within the cross-border framework of prudential authorities.[69]

Furthermore, the management of micro-prudential risks is also amongst the targets of the AIFM Directive. Micro-prudential risks are the type of risks which appear in the context of certain services and service providers. Management of micro-prudential risks proved to be important for the European Union as previously there were no appropriate methods to supervise the risk management practices of alternative investment funds. The weakness of risk management practices endangers investors, contractual partners and the market as a whole, while consistent regulation mitigates that risk, and cross-border regulations can reduce the possibility of supervisory authorities engaging in regulatory arbitrage.[70]

The financial crisis of 2007–2009 once again confirmed the need for intervention for the sake of investor protection. Despite that clients of alternative investment funds are usually professional investors, nonetheless they require reliable and comprehensive information services. Previously, the domestic legislation of member states applied a different approach than the EU with respect to corporate governance and disclosure obligations, thus they were not able to provide consistent legal foundations for the reliable functioning of alternative investment funds.

[67] Alternative investment funds are different capital-raising organisations, thus they fall outside of the scope of regulations applicable to traditional investment funds. Alternative investment funds do not emphasize the establishment of diversified portfolios but rather apply large-scale leverage and engage in derivatives transactions.

[68] See Commission (2012) 8.

[69] Prudential regulatory authorities are the capital market authorities.

[70] In the course of a regulatory arbitrage, certain service providers select a country as a place of their operations which is more favourable or less strict with regards to regulations. This decision can incur additional costs, however, the main target is functioning with less burdens.

In the context of alternative investment fund management, the standardization of market rules is able to increase financial stability and the integrity and efficiency of the markets irrespectively of their location.

Hungarian legislation has implemented the AIFM Directive with Act XVI. of 2014 on Collective Investment Trusts and their Managers and Amending Certain Finance Related Acts and with Government Decree No. 78/2014. (III. 14.).[71] Furthermore, the Hungarian regulatory regime applies the framework conditions of the AIFM Directive and implements concepts such as prime dealer[72] and determines feeder funds and master funds. The Act uses the term feeder fund for funds investing in other funds, while funds being the subject of investments are determined as master funds (a type of umbrella fund).

Similarly to the AIFM Directive, Act XVI. of 2014 exempts funds from certain obligations which manage a capital below the threshold of EUR 100 million and funds which manage an unleveraged capital below the threshold of EUR 500 million and does not grant redemption rights to investors for 5 years.[73]

However, contrary to the EU regulatory framework, Hungarian legislation applies Act XVI. of 2014 to funds with the characteristics mentioned above but exempts them in four different aspects. These aspects are in connection with remuneration, risk and liquidity management, redemption policy and consistency between the latter two systems.[74]

The Hungarian regulation also implements the policy of variable remuneration as well, including deferred portion, since a minimum of 40% of the performance-based remuneration has to be deferred over a period of 3–5 years.[75]

Despite the fact that EU legislation does not approach hedge funds in a manner similar to that of the United States, it seems that the Hungarian regulatory framework allows them a wider room to maneuver. Section 23 (2) of Government Decree 78/2014. exempts hedge funds from certain stricter rules in case the expression ‘derived investment fund’ is included in its name furthermore, it has to meet one of the two following criteria. Firstly, the initial investment made by an investor in the fund has to be at least HUF 10 million and secondly, the shares of the fund can only be marketed to professional investors. In the case that these conditions are fulfilled, the overall risk exposure rate of certain positions in derivatives transactions can be specifically determined. Through this method an alternative fund may be established which incorporates two basic characteristics of hedge funds, i.e. large-scale investors and high leverage. Performance-based remuneration is partly deferred. The investments of the fund manager and the investors in the same fund, furthermore, the management thereof can only occur with the involvement of a third person.

[71] Government Decree 78/2014. (III. 14.) on the regulations governing collective investment forms and borrowing.

[72] Prime dealer is the financial service provider providing not only account management but financing services. In the United States, this role is usually taken by investment banks, while in Europe commercial banks are more likely to act as prime dealers.

[73] Section 2 (2) of Act XVI. of 2014.

[74] Act XVI. of 2014. allows exemption from its Section 33, 35 (1), (3), (5) and Section 36.

[75] Annex 13 of Act XVI. of 2014.

7. CONCLUSIONS

In light of this paper, it can be stated that in the investment world, hedge funds are the funds promising high profits, however, this is paired with risky investment policy and usually trading in one direction. Their popularity is undiminished, even if in many cases their investment policies causes losses to investors and their trading strategies are against the interests of certain national economies. The legal regulation of hedge funds is still flexible even though there were several attempts both on European and global levels by legislators to set a framework for their functioning following the 2007 crisis. These regulations could not hinder hedge funds in applying their techniques and achieveing their goals. The reason of this is that the services of hedge funds are mainly used by the 'high society' of investors fond of trading strategies promising higher profits along with higher risks. Hedge funds do not generate, but rather secure the circumstances in accordance with the market demand. Hedge funds are interested in the creation of an overly motivated sphere of investment, which, taking into consideration low interest rates, is able to provide outstanding profits to clients. The uncustomary strategies of hedge funds have also had a significant impact on the approach taken by traditional investment funds.

However, it has to be taken into account that the systemic risk emerging in the wake of hedge funds had been recognized by most states and thus stricter rules have been implemented as a consequence of past experiences. These reforms could be justified or called into question based on market events in the upcoming years and will be largely based on the degree of efficiency shown by state-and federal regulatory authorities.

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Challenges Facing China

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Abstract: This article examines economic and other challenges that China is facing. It has completed its cycle as a high-growth, low-wage country and thus from now on, it should have to concentrate on efficiency of the economy. However, there are other issues like corruption, lack of cheap work force, lack of market liberalization, and political issues which will need to be addressed.
Keywords: China, economy, reform, challenges, debt, corruption, future

1. INTRODUCTION

China, according to most experts in the field, has completed its cycle as a high-growth, low wage country.[1] This means, that until now, China tried to maximize investment (like Japan, South Korea did few decades ago), but from now, it will have to maximize return on investment – the so-called 'middle income trap'. That is to say, China's economy will have to be more efficient as it shifts to consumer led growth.[2] However, to achieve this, it will have to reduce state control, which is widely present in the current Chinese economy. At the same time, because the new phase includes slower growth, the most likely divergent forces will be contained by an increasingly powerful central government. Economists, therefore, forecast that China will continue to be a major economic force in the world but not the dynamic engine of global growth it once was.[3] In the following article, the challenges that China is facing, mainly from economic aspects will be examined.

2. ECONOMIC CONSIDERATIONS

The size and huge resources of China means that the Chinese economy has been based on the idea of mobilisation of resources, without any concerns on the efficiency of using these resources. Arthur Kroeber noted that 'visitors to China observe the waste and inefficiency visible everywhere and often conclude that the economy will soon hit a crisis.'[4] Realising the 'middle income trap'; that the economic growth is slowing down, and that domestic demand has become a new growth engine,[5] it seems that the Chinese leadership tries to postpone the problem by keeping living standards and employment high, instead of

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** Associate professor, Educons University, FEPPS, e-mail: tamara.gajinov@gmail.com. This thematic issue (Missed and new opportunities in world trade. Eds. Csongor István Nagy & Zoltán Víg) was published as part of the research project of the HAS-Szeged Federal Markets 'Momentum' Research Group.

1 Stratfor (2015) link 5, Howitz (2016) 4, Prasad (2015) 3.

2 Saich (2017) 1.

3 Kroeber (2016) 235.

4 Kroeber (2016) 22.

5 Maliszewski (2016) 1.

improving quality (efficiency). As a result, unemployment is very low – a merely 4.09% in 2014.[6] The reason for this might be the leadership's fear of social unrests, what is understandable considering that China has gone from being one of the most equal countries in Asia to one of the most unequal.[7] Thus, China tries to artificially maintain growth by major investments into infrastructural and housing projects, altering banking supervision, devaluing its currency and changing laws for some industries that can hopefully create larger economic growth.[8] Investments are typically financed through state-owned banks. However, investing money into infrastructure in China is not generating any more high return and growth.[9] This is shown by the deterioration of China's GDP growth rate from 10.61% in 2010, to 6.7% in 2016.[10] All this results in a reduction in the asset quality of banks. It might be also a problem that China's credit expansion is very fast compared to other economies.[11] The Government has created a long term unsustainable credit expansion and banks lowered the lending standards to increase profits.[12] IMF experts point out that there is a very high 'credit gap' comparable to countries that experienced painful deleveraging, like Spain, Thailand, or Japan. They also draw the attention to the credit-to-GDP ratio is significantly higher than in countries at a similar level of development.[13] In addition, there is considerable shadow banking activity in the country.[14]

At the same time, the structure of the Chinese debt is very interesting with the central Government's debt is low, a mere 4,328.52 billion U.S. dollars in 2015[15] whilst corporate debt is very high. The reason might be that credit is centrally distributed to huge state owned enterprises and not on market bases to productive enterprises, like earlier in South Korea. The "economic officials of the reform era inherited a country virtually without legal or regulatory systems". China therefore found it convenient to regulate via the controlled enterprises, rather than through impotent regulatory agencies.[16] Figure 1 shows the distribution of debt in China and in some other global countries and the ratio of corporate debt is highest in China.

[6] Statista (2016) link 8.

[7] Saich (2017) 1. The Guardian (2017) link 6, Kroeber (2016) 22.

[8] Prasad (2015) 3, Georgievski (2016) 156.

[9] According to Smith, China's declining growth rate is 'not something cyclical, based on the prolonged aftermath of the 2008 global financial crisis, but something structural that will affect China's growth over the long-term'. Smith (2017) 9.

[10] Statista (2016) link 8.

[11] Maliszewski (2016) 1.

[12] Georgievski (2016) 167.

[13] Maliszewski (2016) 2.

[14] Georgievski (2016) 167.

[15] Statista (2016) link 8.

[16] Kroeber (2016) 13.

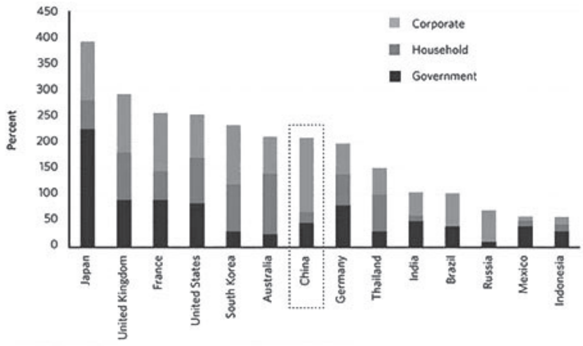

Figure 1. Debt-to-GDP ratios
[source: Carnegie Endowment (Bank for International Settlements, IMF, Goldman Sachs)]

The return on invested capital in these huge state owned enterprises is declining from the last economic crisis and the gap is widening between state owned and privately owned companies (Figure 2). This is happening in despite state owned enterprises having privileges when borrowing money from banks.[17] This process is followed by deteriorating debt servicing capacity of these companies.

This is an alarming sign considering that state owned enterprises are the main tool of the economy, through the state investments programs.[18] The Party promised to reform the system, and make it more market based, however, these enterprises are of prime importance for the Party, both from political and economic aspects[19] and will presumably not be passed over the whims of the market. Experts forecast state-owned enterprise reform with so-called 'Chinese characteristics'. One direction is merger of central state owned enterprises.[20] Another way the government tries to solve the problem is winding up loss making companies and those in non-strategic sectors; to broaden ownership and improve efficiency in state owned companies. However, this strategy used many times done selectively and only in certain sectors.[21]

[17] Maliszewski (2016) 7.
[18] Zhou (2017) 1.
[19] Zhou (2017) 2.
[20] Zhou (2017) 5.
[21] Maliszewski (2016) 8, Saich (2017) 9.

Figure 2. SOE productivity (source: Gavekal Dragonomics)

The mentioned huge investment projects and related problems are well illustrated by the construction boom, which is very much over. There are several ‘ghost cities’ in China. These real estate and infrastructure projects were extremely inefficient and also involved corruption. By investing into such projects, the Government bought additional time, but at the same time, enlargened the problem. These investments are not bringing long term profits.

The Government realized these issues and tried to move the capital to the private sector where the return is higher. It also introduced some reforms in the financial sector, like interest rate liberalisation. Renminbi, the Chinese currency, is also used more in trade settlements.[22]

China is gradually moving towards market based currency rate. The majority of experts forecast that in future the Chinese currency will depreciate as it is tiedo a basket of currencies, not only to the dollar. However, it should be mentioned that Chinese regulation is still not in accordance with International Financial Reporting Standards, there is serious lack of transparency in the financial sector and a sizeable shadow banking The calculation method for the loan-deposit ratio, as previously mentioned above, is very flexible, and the Government is constantly lowering reserve requirement ratio and banks can grant more credit.[23] This way the Government is artificially increasing liquidity of Chinese banks.[24]

General market liberalisation started with the ‘open door policy’ end of 1970s as a transition from state controlled and closed economy to market economy, and economic growth was based on foreign trade and foreign investment, bringing capital, technology, management knowledge, etc.[25] It still seems that the Government still broad policies and allocates the majority of resources.[26] Kroeber finds this paradoxical as ‘an apparently

[22] Saich (2017) 10.

[23] Georgievski (2016) 168.

[24] Smith (2017) 13, Georgievski (2016) 168.

[25] Conkling (1997) 93. This is a difference between China and other East Asian models. Kroeber (2016) 14.

[26] At the same time, Kroeber notes that there is an unusually high level of fiscal decentralisation for an authoritarian country like China. Kroeber (2016) 4.

centralized, one party authoritarian state presiding over a dynamic, decentralized economy.'[27] Thus, there is still no real information about the market – a serious obstacle for foreign investors.[28] President Xi has promised that market forces will be more 'decisive', however, it seems that this is not coming true.[29]

There is another reason for lack of private capital – the majority of domestic investors are taking their money abroad as a result of anti-corruption laws. President Xi launched an anti-corruption campaign under the slogan 'catching tigers and flies' resulting in the arrest of several high and low ranking officials.[30] A study carried out by Chen and Zhong revealed that it is not only the political elite that profit from corruption, but also wider social-economic classes. Therefore, anti-corruption legislation affects not only bureaucracy but the private sector as well. Paradoxically, these laws increase the cost of entry to the market for the private sector. The study concludes that 'the negative impact of anti-corruption on business registration suggests corruption may help reduce entry barrier.'[31] Thus, effective anti-corruption laws slow down economic growth.[32] Other sources support this view explaining that local and other officials think it is safer to do nothing rather than approve investments or making decisions which may lead to accusations of misuse of power.[33] The 2016 report of Corruption Perception Index of Transparency International also shows how serious problem is corruption in China, ranking it at the 79th place among 176 countries.[34] According to a recent poll corruption is a top concern of the Chinese citizens.[35] All in all, corruption is a huge problem in China that affects the economy.[36]

3. OTHER CONSIDERATIONS

Demographics might be also an issue for the Chinese economy.[37] During the last few decades there was a favourable demographic situation in China as the dependency ratio was good, that is to say the ratio of dependent young and old people to productive workers. It was between 40 to 100 productive workers during the peak and in addition, more than 200 million workers have migrated from the countryside to the cities during the last 30 years. These unskilled people were trained in factories and became cheap work force in the cities.[38] The urban population percentage changed from 43.87% in 2006 to 56.78% in 2016.[39] The dependency ratio is deteriorating, and in some areas of China, there is lack of cheap work force. Some workers are even imported from abroad e.g. Vietnam.[40] Fertility

[27] Kroeber (2016) 5.
[28] Smith (2017) 6.
[29] Smith (2017) 15.
[30] Saich (2017) 6.
[31] Chen (2017) 4.
[32] Chen (2017) 17.
[33] Saich (2017) 5, Chen (2017) 7.
[34] Transparency International (2016) link 7.
[35] Chen (2017) 4.
[36] Lately, Minxin Pei has published a good book on crony capitalism in China.
[37] Smith, (2017) 5.
[38] Smith (2017) 11.
[39] Statista (2016) link 8.
[40] China Daily (2017) link 1.

rates are also below replacement value, 1.57 children born per woman in 2015.[41] The result is that wages are rising and it has a negative effect on the competitiveness of the Chinese economy. Figure 3 shows the population age pyramid and there is no too much hope for improvement. A related issue is the huge difference in living standard between inland parts of China and the coastal regions of the country and Yangtze River Delta. There are plans to close the gap between these regions but if the economic growth slows in the advanced regions, they will not be able to aid underdeveloped parts of the country. Thus, these differences might cause long term tensions.[42]

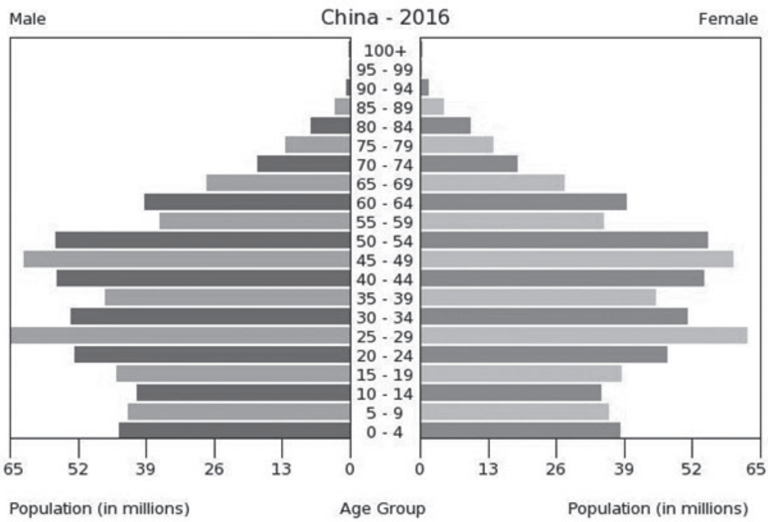

Figure 3. Population age pyramid (source: Index Mundi)

Another issue that has impact on the Chinese economy is environmental pollution. Rapid industrial development without taking into account its consequences to the environment has caused serious ecological issues in China.[43] Its Environmental Performance Index score is 65.1 and ranked 109 out of 180 countries.[44] The condition of major environmental components, air, water and soil has a bleak outlook. China took over from the United States of America the leadership in air pollution in 2007.[45] The main reasons being the extensive usage of coal in the industry, the growth of traffic, and of course, the emission of factories. There is a related higher number of cardiovascular, lung and other

[41] Statista (2016) link 8.

[42] Stratfor (2015) link 5.

[43] Cantoni (2016) 67-68, Mujačević (2015) 583.

[44] The Environmental Performance Index (EPI) is constructed through the calculation and aggregation of more than 20 indicators reflecting national-level environmental data. These indicators are combined into nine issue categories, each of which fit under one of two overarching objectives. This section provides an overview of how the EPI is calculated. Complete methodological details and indicator-level metadata are available at: EPI (2014) link 2.

[45] Albert (2017).

disorders in the population.[46] All this result in high public health costs. Life expectancy is also stalling as a result, only increasing from 73.77 years in 2005 to 76.00 in 2015 despite the rapid economic growth and significantly increased quality of life.[47]

There is also issues with the quality of waters, soil, desertification, energy efficiency, etc.[48] It seems that the State still prefers economic growth to environmental protection.[49] The strong competition and lack of regulation in some fields resulted that the producers sometimes do not respect even basic environmental standards. However, experts hope that China is reaching the peak of the 'Kuznets curve' (Figure 4) and the situation is going to improve during the years that follow (less polluting technology is used, etc.). (At the same time, it should be noted that the theory related to the Kuznets curve has its deficiencies.).

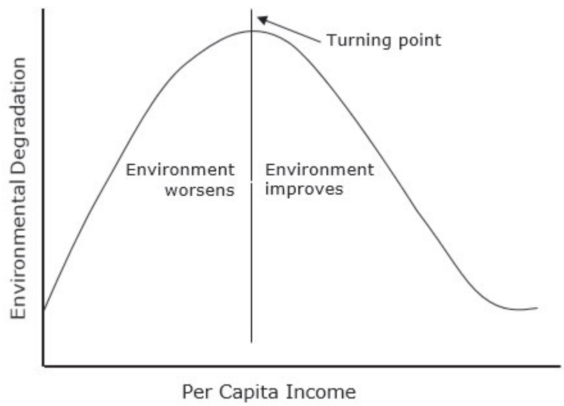

Figure 4. Kuznets curve

At the same time, there are some promising signs, there has recently be fall in the consumption of coal was recorded and a certain improvement in the air quality due to more than hundred most polluting factories being closed down during the last year, and new vehicles were introduced into the traffic, some with electric engine.[50] China is also investing extensively into renewable energy and is a global leader in wind energy production. The number of environmental activists is constantly rising in the country and also the awareness and conscience of people is also changing. The Government and the Party have to find the balance between economic and environmental interests. However, this will not be an easy task as still the main goal is to maintain economic growth.[51]

A few words should be devoted to domestic and foreign policy as well, as they have huge effect on the economy as politics actually determines economic system. The main political issue currently is also related to the economy of the country – how to find the balance between maintaining power and control of the Party and maximizing economic growth in the country. The Chinese leadership has been good at this during the last few

46 Kineska ekologija, energetika i ekonomija (2015) link 3.
47 Statista (2016) link 8.
48 Lallanilla (2013) link 4.
49 Amesheva (2017) 427–30.
50 Zhang (2016) 1307.
51 Amesheva (2017) 427–30.

decades. They have even researched the collapse of the Soviet Union. Allegedly, Deng Xiaoping once said that Michail Gorbachev was an idiot for putting political reforms ahead of economic ones.[52] Until now, the Party has handled the issue relatively flexibly, prioritising the economy, understanding its importance.[53] However, currently it seems that political and economic powers are getting more centralised, nationalism is in rise, and all this will certainly have effect on market oriented reforms in the economy.[54]

Foreign policy has also effect on the economy in as much as it seems assertive in its foreign policy e.g. building artificial islands, etc. Currently, China has no interest to be internationally aggressive and having its own sphere of interest might be costly. Besides, China is both a huge importer and exporter in the region and worldwide. For example, the United States of America is China's leading trade partner ($520 billion of total trade in 2016), and China is the US' third largest.[55] The large amount of exports by China is also shown by the country having a trade surplus of 593 billion USD in 2015.[56] In the long run, an exception might be Russia's maritime interests in the East. However, if China has no interest in developing its own sphere of interest, why does it increasingly focused on soft cultural power and indirect influence through international investments? Are these merely signs of China trying to assert its own identity or that China has greater plans for the world?

4. CONCLUSIONS

It can be generally concluded that China should shift to a growth model that emphasizes quantity over quality. Resources should be used more efficiently. However, in a system like the Chinese, such thorough changes can be carried out only centrally.

The 19th Congress of the Chinese Communist Party took place in the autumn of 2017 with a strong focus on internal issues. Xi Jinping has strengthened his positions as the General Secretary's and the Chairman of the Central Military Commission. It is true that his highly centralized approach to economic policymaking is a departure from the usual practice over the prior three decades and that he has built up a powerful bureaucracy.[57] However, it is still a question how will he react when faced with the problem of choosing between economic reforms and strengthening the party. It also bears mentioning that Mr. Xi is not only strengthening his position but is also increasingly moving towards a more centralized system. Systems, such as these, tend to be dominated by political, and not economic considerations.

Some analysts suggest that

First, the government should act quickly before the problem becomes systemic. Second, the problems of both creditors and debtors should be tackled together. Just cleaning up the banks by moving bad loans off bank balance sheet and recapitalizing the banks, or allowing companies to go bankrupt without recapitalizing banks would not revitalize economic activity. Third, the governance problems in the corporate

[52] Kroeber (2016) 8.
[53] Stratfor (2015) link 5, Smith (2017) 7.
[54] Stratfor (2015) link 5.
[55] Smith, (2017) 4.
[56] Statista (2016) link 8.
[57] Kroeber (2016) 18. Georgievski (2016) 170.

sector and the banks that gave rise to the problem should be addressed to prevent the re-emergence of a vicious credit cycle.[58]

Saichs' prognosis is that

> There would be a dominant executive with a weak legislature and a fragmented civil society overseen by a strong domestic security apparatus and military. The leadership would stress the fear of social chaos to keep the middle class supportive with a stronger nationalism to cement patriotic cohesion.[59]

However, Arthur Kroeber for example, is more cautious and forecasts more scenarios. One of them is that economic reforms will be carried out (bankrupt state enterprises shut down, banks recapitalised) under tight party control and thus growth will settle at 5%, with a limited expansion of rights. Another scenario is that economic reforms will be judged too destabilising, therefore growth will slow sharply and nationalism will be strengthen. The last scenario is entrenched political-economic bargains, which impede reforms, thus resulting in low growth and high dept trap.

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